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The EBRD aims to foster the transition from centrally planned to market economies in countries from central Europe to central Asia.

The EBRD’s countries of operations are: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Mongolia, Montenegro, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

The EBRD works through the Legal Transition Programme, which is administered by the Office of the General Counsel, to improve the legal environment of the countries in which the Bank operates. The purpose of the Legal Transition Programme is to foster interest in, and help to define, legal reform throughout the region. The EBRD supports this goal by providing or mobilising technical assistance for specific legal assistance projects which are requested or supported by governments of the region. Legal reform activities focus on the development of the legal rules, institutions and culture on which a vibrant market-oriented economy depends.

Information about the EBRD’s Legal Transition Programme can be found at www.ebrd.com/law.
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Foreword
Sound and effective regulation, and the confidence it brings, are important for the integrity and growth of securities markets. Securities markets are vital to the strength and development of market economies. They support corporate initiatives, finance the realisation of new ideas and facilitate the management of financial risk. Furthermore, since retail investors are placing an increasing proportion of their money in mutual funds and other collective investments, securities markets have become central to individual wealth and retirement planning.

The International Organization of Securities Commissions (IOSCO), which was founded in 1983, is recognised as the primary forum for international cooperation among securities regulators and as the global standard setter for the regulation of securities markets. IOSCO’s Objectives and Principles of Securities Regulation (the Principles), were adopted in 1998 and revised in 2002 and set three core objectives for securities regulation:

■ to protect investors
■ to make markets fair, efficient and transparent
■ to reduce systemic risk.

While the Principles are non-binding, they have substantial authority among regulators and governments due to the organisation’s high standing in the global financial community. That standing reflects IOSCO’s experience, its broad international membership, its rigorous processes for drafting standards and agreeing on difficult issues and its network of relationships. IOSCO is recognised as an important part of the international financial architecture by the Financial Stability Forum, the International Monetary Fund, the World Bank and others.

IOSCO seeks cooperation and consultation with all organisations that can contribute to promoting efficiency, fairness and transparency in capital markets at both national and international levels. IOSCO welcomes the use of the Principles by the EBRD in its assessment of securities markets laws. The results are discussed in the lead article of the securities markets section in this issue of Law in transition.

Central and Eastern Europe and the Commonwealth of Independent States are regions of great importance to both the EBRD and IOSCO, which has a strong vision for the future: that by 2010, all 109 members will have signed onto the IOSCO MOU or committed to do so. These countries have a crucial role in achieving this vision, for two reasons. First, their importance is constantly increasing in the global economy. Secondly, their legacy of central planning provides some challenges for the implementation of the Principles.

IOSCO closely monitors developments in the international securities markets, identifies issues as they arise and sets up working groups and project teams to address these. Although the phase of establishing standards is mature, the crucial work of implementing these standards worldwide has some way to go. In many jurisdictions, regulatory reforms are underway and it is important that these meet IOSCO standards. As shown by recent research by the EBRD – published in this issue of Law in transition – the number of countries in CEE and the CIS harmonising their legislation with the Principles is increasing, but practical implementation is lagging behind.

Implementation is one of IOSCO’s key priorities and the organisation is forging ahead to promote the consistent and comprehensive implementation of the Principles in all member jurisdictions. The other articles included in this journal, dedicated to Albania, Moldova and Kazakhstan, evidence the efforts undertaken by IOSCO members and policymakers in developing effective frameworks.

IOSCO welcomes the current issue of Law in transition as an excellent opportunity to stimulate the discussion and dialogue between all market participants who strive to achieve appropriate, efficient and fair standards for securities regulation. This, we hope, will increase the integrity of the markets and bring benefits for both investors and issuers of securities.

Jane Diplock
Chairperson of the IOSCO Executive Committee
Part I

Securities markets are essential for the development of national economies. By fostering savings and investments, they drive development and private sector growth. All of the EBRD’s countries of operations have a framework in place regulating securities markets, equities transactions, stock exchanges and market regulators activities, but actual market functioning differs considerably among the countries. Some markets show high capitalisation and liquidity, others are inactive or register only very few transactions.

A recent study by the EBRD shows that the majority of countries in its region have recently revised their laws in order to improve the framework in line with international standards. The articles in this section discuss whether having good laws on the books is sufficient to boost the market and outline some of the most interesting recent developments in securities markets law and practice.

The first article, authored by Gian Piero Cigna, EBRD Principal Counsel, and Roman Chapaev, of the law firm Chadbourne and Parke, assesses the quality of securities markets legislation in the EBRD region, benchmarking national laws with the International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulations. The article also looks at how the law works in practice, using a case study focused on securities market.

The second article, by Greg Tanzer, Secretary General of IOSCO, looks at the IOSCO Principles, discusses their
rationale, considers the methodology for their implementation and highlights the deficiencies in securities markets legislation that they are designed to tackle.

Ajay Sud, EBRD Principal Counsel, gives an insight of securitisation practices in Russia. Securitisation is a form of “off balance-sheet financing” that is increasingly being used in the EBRD region. It is not only a financing tool, but also a propeller for change in economies that are seeking to modernise their infrastructure. The article reviews the development of the securitisation market in Russia, the efforts that have been made to improve the legal framework, and the challenges that still remain.

In the last few years, many countries have merged their “market watchdogs” into a single authority in charge of securities market, insurance and pension funds. Elisabeta Gjoni, Chairperson of the Albanian Financial Supervisory Authority, provides an outlook of the Albanian experience and the challenges facing the new Albanian authority. In Kazakhstan, the challenge of developing the market has been addressed through the creation of a financial centre. Arken Arystanov, Chairman of the Regulatory Agency for the Regional Financial Centre in Almaty discusses the development of Kazakhstan’s first regional financial centre and evaluates its achievements so far in attracting international investor. Finally, Iurie Tirdea, Senior Lecturer at the Moldovan Academy of Economic Studies, illustrates the latest amendments to Moldovan commercial legislation and describes the role of the recently created single authority for non-banking financial services.
Securities markets legislation in transition countries: law and practice
The quality of the law

In 2007 the EBRD carried out a survey in its 29 countries of operations to measure the extent to which national securities markets legislation in force on 1 June 2007 complied with the Objectives and Principles of Securities Regulation (principles) of the International Organization of Securities Commissions (IOSCO).

More than 200 questions, reflecting key issues of the regulations, were organised into the following 10 sections:
(i) the powers of the market regulator
(ii) self-regulatory organisations (SROs)
(iii) issuer and disclosure obligations
(iv) collective investment schemes
(v) market intermediaries
(vi) secondary markets
(vii) clearance and settlement
(viii) accounting and auditing standards for financial disclosure
(ix) money laundering
(x) regulation of various financial instruments.

The questions were then sent to local practitioners in the transition region. Each question was weighted according to its importance: questions defined by the IOSCO as key issues were assigned a higher weighting. Results were then calculated for each section and ratings assigned to each of them. The sum of the weighted section scores was then averaged to derive a single numerical value for each country.

Based on these results, each country was placed into a grouping that indicated its level of adherence to international standards for securities markets legislation.

No countries in the survey were considered to be in “very high compliance”, a result that would mean the international principles were fully transposed into the national legislation. Fourteen countries were rated as being in “high compliance”, meaning that laws are relatively sound in most areas highlighted by the principles.

Eight countries were scored in the “medium compliance” category, which means they show areas where improvements are needed. Four countries were rated as being in “low compliance” indicating a situation where the general quality of the legislation should be improved. Finally, three countries in “very low compliance” have a legal system that needs urgent reform.

Central eastern Europe and the Baltic states (CEB)

All countries in this region joined the European Union on 1 May 2004, harmonising their legislation with the acquis communautaire, the body of EU law that all countries must adopt to become EU members.

The acquis in the field of securities markets is extensive and substantially in line with the Principles and so all countries in CEB showed high compliance with international standards; legislation on SROs, collective investment schemes, market intermediaries and money laundering appeared particularly sound.
Quality of securities markets legislation in transition countries

Note: The charts show the compliance of national securities markets legislation with international standards. The extremity of each axis represents an ideal score of 100%, i.e. full compliance with the relevant standard set forth in IOSCO’s Objectives and Principles for Securities Regulations. The fuller the ‘web’, the closer the overall securities markets laws of the country approximate these principles.

Source: EBRD, Securities Markets Legislation Assessment 2007
Securities markets legislation in transition countries

Latvia

Lithuania

Moldova

Mongolia

Montenegro

Poland

Romania

Russia

Serbia

Slovak Republic

Slovenia

Tajikistan

Turkmenistan

Ukraine

Uzbekistan
Latvia showed the best overall legal framework for securities markets, followed by Lithuania (see Chart 1 on page 9). Poland showed sound regulation in most sections under consideration but the law does not ensure complete independence of the regulator and its provision with the appropriate regulatory authority. In the Czech Republic, legislation on the monitoring of large exposure needs to be strengthened, while in Slovenia and Estonia the framework on the listing and trading of derivatives and bonds is not sufficiently comprehensive.

Finally, in Hungary, the regulator’s duties and responsibilities and the framework on clearing and settlement are not fully in line with the principles. However, these are all only limited flaws; the overall framework in CEB is generally coherent and sound.

South-eastern Europe (SEE)\textsuperscript{4}

As in CEB, all countries in SEE have harmonised or are still harmonising their national laws with the \textit{acquis communautaire}: Bulgaria and Romania are members of the European Union, Croatia and the former Yugoslav Republic of Macedonia are EU candidate countries while Albania, Bosnia and Herzegovina, Montenegro and Serbia are potential candidate countries.

Bulgaria, Croatia and Romania showed the best frameworks and only minor flaws were reported. Serbia also has a regime that is substantially in line with the principles, but the regulation on listing and trading of bonds and derivatives needs to be improved. There are also some concerns connected to the harmonisation of the securities framework with other areas of law.

Commonwealth of Independent States and Mongolia (CIS+M)\textsuperscript{5}

With the notable exception of Moldova and Ukraine – which showed substantial improvements since the last EBRD assessment in 2005 – the securities markets framework in the CIS+M is showing problems in several of the sections under consideration. Kazakhstan, Mongolia, Tajikistan and Turkmenistan have insufficient legislation on money laundering. Belarus, Georgia, the Kyrgyz Republic, Mongolia, Tajikistan and Turkmenistan have a weak framework or none at all on collective investments. Russia is very close to the high compliance category but some important issues, such as the regulation of investment advisers and derivatives and the introduction of a

Note: In Bosnia and Herzegovina two distinct assessments were made to assess the quality of legislation in the Federation of Bosnia and Herzegovina and in the Republika Srpska. The overall result is the average of the two assessments, weighted by population.


| Compliance with IOSCO’s Objectives and Principles for Securities Regulation |
|------------------------|------------------------|------------------------|------------------------|
| **Very high compliance** (No countries) | **High compliance** (14 countries) | **Medium compliance** (8 countries) | **Low compliance** (4 countries) | **Very low compliance** (3 countries) |
| Bulgaria | Croatia | Czech Republic | Estonia | Hungary | Latvia | Lithuania | Moldova | Poland | Romania | Slovak Republic | Serbia | Slovenia | Ukraine | Armenia | Bosnia and Herzegovina | FYR Macedonia | Kazakhstan | Kyrgyz Republic | Mongolia | Montenegro | Russia | Albania | Azerbaijan | Georgia | Uzbekistan | Belarus | Tajikistan | Turkmenistan |

Table 1

Quality of securities markets legislation in transition countries

Securities markets legislation in Belarus, Tajikistan and Turkmenistan is in urgent need of overall reform.
central depository, still need to be properly addressed. Finally, securities markets legislation in Belarus, Tajikistan and Turkmenistan is in urgent need of overall reform.

How the law works in practice: the Legal Indicator Survey

The Legal Indicator Survey (LIS) conducted in 2007 focused on the effectiveness of securities markets legislation in the Bank’s countries of operations. Instead of looking at the laws on the books, it aimed to assess how the laws work in practice. To achieve this, the survey took the perspective of an investor facing substantial losses after having purchased some shares in a well-known company on the basis of wrong information included in the company’s prospectus (see Box 1).

The survey looked at how such an investor can obtain compensation, gauging the effectiveness of legislation on disclosure, the market regulator and private and public enforcement mechanisms.

Box 1

Hypothetical case study

A bank established in your country underwrote shares of a well-known national company during its initial public offering (IPO).

The IPO prospectus included audited annual accounts provided by the issuer to the underwriter, but the consolidated financial statements included in the prospectus omitted to account for substantial debts of the affiliated companies of the group.

This omission was due to a mistake in the consolidated financial statements. Shortly after the issue, international newspapers published negative information about the group, the mistake was revealed and the share price plummeted.

Your client bought shares in the local company from the underwriter during the IPO and now asks advice on what can be done to recover the losses. Please advise your client accordingly.

Methodology

The methodology employed follows on from previous EBRD surveys and, accordingly, it involved working with law firms in the region. These firms were provided with the above-mentioned scenario and a checklist with a series of supplementary questions related to the case study.

Local counsel were instructed to respond to the checklist as if they were advising a client on how best to protect their interests and preserve the value of the investment. Countries were then graded on a scale of 0 to 10, based on the analysis made by the local practitioners and a team of EBRD lawyers. In this scale, zero indicates very low effectiveness and 10 very high effectiveness of the national securities markets legislation.

In particular, respondents were asked to provide the necessary information to assess the effectiveness of:

(i) Prospectus disclosure requirements

The prospectus is a formal legal document that provides details about an investment offering for sale to the public and details the facts an investor needs to know in order to make an informed investment decision. This category assesses the implementation of the principles of disclosure and transparency and reflects the breadth and reliability of a prospectus, covering in particular the degree of disclosure, risk identification, quality of financial reporting, institutional oversight and distribution practices.
(ii) Private and public enforcement mechanisms

Securities markets are regulated by law. Abuses and breaches of law might cause substantial losses to investors, which rely on enforcement institutions for the protection of their rights.

The LIS covers both private (civil) and public (criminal/administrative) enforcement mechanisms. Private enforcement establishes whether an investor can reasonably expect to recover damages through court action. The factors taken into account are: the range of legal actions (assessing the best avenue possible), liability standards and burden of proof, recovery chances, the speed and cost of the action and the quality of the institutions that administer the private legal action.

The public enforcement category analyses the capacity and experience of the relevant institutions when pursuing administrative and criminal actions for more serious breaches of laws or rules of conduct, when the initiative of the plaintiff is not required. It considers the effectiveness of actions by the regulator, the prosecutor and the courts, their capacity, the liability criteria and the applicable sanctions.

(iii) Market regulator

The regulator is the market watchdog. Its authority and power are fundamental for market development and trust. The LIS assigns a grade to the securities markets regulator, based on its independence, impartiality, experience and finally its rule-making, investigative and sanctioning powers.

Stock exchanges in the EBRD’s countries of operations

An assessment of the effectiveness of securities markets legislation implies that a functioning securities markets does actually exist. However, in some of the EBRD’s countries of operations the stock exchange lacks liquidity or IPO practice is absent. In such cases, the results of the assessment should be considered to be purely hypothetical.

Central eastern Europe and the Baltic states

All countries in CEB have reasonably well-functioning stock exchanges, in particular those of Budapest, Prague and Warsaw. However, with the exception of Poland these markets are still rather small. In particular, the liquidity of the Bratislava and Riga stock exchanges is low. Accordingly, for the purposes of the LIS, the results should be viewed very cautiously.

South-eastern Europe

When compared with CEB, the number of active stock exchanges and their liquidity in SEE is rather low. IPOs are not a common vehicle for corporate financing and only in Bulgaria, Croatia and Romania have some primary and secondary offerings recently been reported. The market is inactive in Albania and illiquid in Bosnia and Herzegovina, where no IPOs are registered.

Commonwealth of Independent States and Mongolia

In Armenia, Georgia, Kazakhstan, the Kyrgyz Republic, Mongolia and Russia stock exchanges do have some liquidity. IPOs in the last year were reported to have taken place in Kazakhstan, Moldova, Mongolia and Russia, but only the Russian stock markets has a level of liquidity that is comparable to CEB markets. In Tajikistan and Turkmenistan there is no active market, while trading is extremely limited in Azerbaijan, Belarus, Ukraine and Uzbekistan.

Results

Measuring the effectiveness of a legal mechanism is a difficult exercise and the findings must therefore be treated with caution. First, they reflect views of a limited number of law firms within each country. Secondly, they address a very specific set of circumstances and must be considered within the boundaries of the case study (see Box 1). Thirdly, assessing effectiveness is by far a more difficult and subjective exercise than simply analysing legislation on the books.
Securities markets legislation in transition countries

Prospectus disclosure requirements

Central eastern Europe and the Baltic states

Disclosure practices in CEB are generally sound. The documentation included in the prospectus is reliable and financial reporting practices are good in the whole region. EC Regulation 809/2004 directly applies detailed prospectus disclosure requirements in all EU countries and is well implemented. Especially high standards can be found in Poland (see Chart 2).

South-eastern Europe

Bulgaria and Romania implement the highest transparency standards in SEE. In both countries EC Regulation 809/2004 applies and its effect is beneficial for the quality of disclosure practices. In Bosnia and Herzegovina, financial reporting is good and information included in the prospectus is generally considered to be reliable. In FYR Macedonia and Serbia, financial reporting practices are sound but the scope of information included in the prospectus is limited. Albania and Montenegro showed serious shortcomings in all variables under consideration.

Commonwealth of Independent States and Mongolia

Disclosure practices in the CIS+M are generally of a lower standard than in CEB and SEE and prospectuses often omit risk-sensitive information. In Russia, prospectuses cover a broad range of issues but, as in most countries in this region, they need not include the issuer’s indirect ownership.

In Russia, prospectuses cover a broad range of issues but, as in most countries in this region, they need not include the issuer’s indirect ownership.

Note: The chart shows the scores for each country regarding disclosure practices. Scores are calculated on a scale of 0 to 10, with 10 indicating full effectiveness.
Survey estimates are hypothetical for those countries indicated with transparent colours, as the relevant securities markets is relatively illiquid or there were no recent IPOs.
Private enforcement mechanisms are especially effective in the Czech Republic, Estonia and Hungary. The recovery rate is particularly high in the Czech Republic, while it is below average in Lithuania.

Private and public enforcement mechanisms

When considering private enforcement mechanisms, three lawsuits can be considered: (i) against the issuer, who sold the shares; (ii) against the underwriter, who concluded the contract with the investor; and (iii) against the auditor, who made a mistake in opining on the consolidated financial statements.

When assessing public enforcement mechanisms, two actions can be foreseen: administrative action by the market regulator and criminal action by the prosecutors, provided that administrative or criminal provisions have been breached.

Central eastern Europe and the Baltic states

Private enforcement mechanisms are especially effective in the Czech Republic, Estonia and Hungary. The recovery rate (how much the investor is likely to recover) is particularly high in the Czech Republic, while it is below average in Lithuania. In the majority of countries, courts are experienced in corporate cases but they may still lack the expertise for a deep analysis of a complex securities markets case.

When looking at public enforcement mechanisms, the LIS revealed that regulators are developing their expertise in investigating complex securities cases. However, the corresponding capacity for public prosecution remains low. Insider trading is considered to be a serious risk in all countries, but only in a few states have sanctions been applied in practice. Only in Lithuania and in the Slovak Republic are public enforcement mechanisms perceived to be more effective than private ones. In both countries the burden of proof for the plaintiff might be heavy, which renders the respective actions complex.

Chart 3

How securities markets laws in transition countries work in practice.

Effectiveness of private and public enforcement mechanisms.

Note: The chart shows the scores for each country regarding private and public enforcement mechanisms. Scores are calculated on a scale of 0 to 10, with 10 indicating full effectiveness. Survey estimates are hypothetical for those countries indicated with transparent colours, as the relevant securities markets is relatively illiquid or there were no recent IPOs.

South-eastern Europe

There are several private enforcement mechanisms that investors can rely on for recovering damages. These mechanisms are considered particularly effective in Bosnia and Herzegovina, Croatia and Romania, where the framework is clear in pointing out which are the parties responsible for the correctness of the prospectus, therefore making litigation less complex. Judgments are less predictable in Albania and Serbia and the recovery rates are the lowest in the region.

When assessing public enforcement mechanisms, the survey revealed an uneven situation: in Bulgaria, Croatia and Romania the regulator is considered capable of complex investigations, while in Albania, Bosnia and Herzegovina and FYR Macedonia doubts are expressed over the prosecutor’s capacity to investigate complex financial cases.

Only in Serbia are public enforcement mechanisms considered more effective than private ones, which, with reference to the LIS case study, are subject to complex burden of proof and leave little chance of a reasonable recovery of losses.

Commonwealth of Independent States and Mongolia

In Georgia, Moldova and Russia private enforcement mechanisms were found to be relatively effective with an especially high recovery rate in Georgia. In Kazakhstan, the Kyrgyz Republic, Tajikistan and Ukraine available civil actions are perceived to be complex, while in Mongolia enforcement procedures are not effective. In all countries, the capacity and competence of courts in corporate cases need to be improved.

Market regulator

Central eastern Europe and the Baltic states

Lithuania showed the most effective framework with respect to the position, authority and responsibilities of the market regulator. The Lithuanian Securities Commission has the authority to regulate and supervise the securities markets, including pension funds. It is independent and has effective regulatory, investigative and sanctioning powers.
In Latvia, securities markets supervision has been conducted under single authority since 2001: the Financial and Capital Market Commission supervises Latvian banks, insurance companies and insurance brokers, participants in the market for financial instruments and private pension funds. It is independent and has effective regulatory authority but lacks the necessary investigative powers to perform complex investigations.

In Estonia the market regulator is the Financial Supervisory Authority, an agency of the Bank of Estonia, which supervises the securities and insurance markets and banking. It has effective investigative and sanctioning powers, although no regulatory authority. The same issue occurs in Poland, where the new Capital Market Supervision Act established the Polish Financial Supervision Authority, which took over the tasks of the Insurance and Pension Funds Supervisory Commission and of the Securities and Exchange Commission. From 1 January 2008 the authority is also responsible for banking supervision, which was previously performed by the Banking Supervisory Commission.

The Slovenian Securities Markets Agency was established in 1994 and is an independent agency, financed by market participant fees. It is in charge of licensing new securities issues and supervising the securities market. It has appropriate rule-making authority but limited investigative and sanctioning powers.

South-eastern Europe

Bulgaria and Romania have the two most effective frameworks in SEE. The Bulgarian Financial Supervision Commission is in charge of regulating and supervising securities, insurance and pension funds. In Romania the National Securities Commission regulates and supervises the securities markets while the National Bank of Romania is in charge of the banking sector and the Insurance Supervisory Commission covers the insurance market. In Albania the recently established Financial Supervisory Authority, in charge of the securities, insurance and pension fund sector, is faced with the challenge of rebuilding the trust necessary for these markets to develop. It seems to be fairly independent but it might lack the necessary investigative and sanctioning authority.

Commonwealth of Independent States and Mongolia

In most countries in the CIS+M region the system does not provide the regulator with independence from political pressure. In Russia the regulator is not completely independent from the Executive. Its capacity to supervise the issuers is effective but its authority is seldom exercised. In Turkmenistan the functions of the securities markets regulator are entrusted to the Ministry of Finance. Its authority and powers extend beyond mere supervision. In certain instances, the ministry can enquire into the merits of an issue. This form of control is too tight to allow a market to develop effectively.

In Moldova, after a lengthy reform, the regulator seems to be able to perform its duties more effectively, but further efforts are needed to develop the market.12

Conclusion

Sound and effective regulation and, in turn, the confidence it brings is important for the integrity, growth and development of securities markets. The EBRD assessments show that the majority of jurisdictions with functioning stock markets have legislation in high compliance with international principles. But good laws alone are not enough to create efficient markets. Investment opportunities need to be backed by a solid institutional environment, capable of inspiring trust and attracting investors.

In CEB, good investment opportunities have been highlighted by the European market. Further, the implementation of the EU’s acquis and the strengthening of the cooperation between regulators have contributed to the creation of an effective framework where investors enjoy a good degree of protection.

SEE follows closely, as high influence is exerted by the goal of joining the EU market and much effort is dedicated to the harmonisation of national legislation and practices with EU standards.

In the CIS+M – when compared with the CEB or SEE – the degree of investor protection varies significantly among countries. Overall, much work still needs to be done: both the quality and effectiveness of regulation need to be improved in order to strengthen investors’ confidence and trust in the markets.
Notes

1. The authors acknowledge the kind contribution of Aleksandr Livshits to the EBRD research projects on which this article is based.

2. This region includes the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia.

3. Large exposures are open positions or credit exposures on unsettled trades that are sufficiently large to constitute a risk to the market or to a clearing firm.

4. This region comprises Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Montenegro, Romania and Serbia.

5. For a detailed analysis of the reform currently undergoing in Albania, see the relevant article, Albanian Financial Supervisory Authority, in the present issue of Law in transition, page 32.

6. This region includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Mongolia, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

7. The scenario mirrors genuine, securities scandals, for instance, the Italian CIRIO case in 2002 or the ABN Amro-Coopag Finance BV case which occurred in the Netherlands in 1987-88.

8. Among others, the following law firms contributed to and supported the 2007 securities markets legislation assessment and the 2007 LIS: Studio Legale Tonucci (Albania); OMNI Consultants (Azerbaijan), Borovtsov & Salei Law Firm (Belarus); Advokat Branko Maric (Bosnia and Herzegovina); CMS Cameron McKenna (Bulgaria, Czech Republic, Hungary, Poland and Romania); Wolf Theiss (Croatia, Serbia, Slovak Republic and Slovenia); Luiga Mody Haal Borenius (Estonia, Latvia and Lithuania); Polenak Law Firm (FYR Macedonia); Mgaloblishvili, Kipiani, Dolodzigu (Moldova) Law Firm (Georgia); Chadbourne & Parke LLP (Kazakhstan, Russia, Ukraine and Uzbekistan); Kalikova & Associates (Kyrgyz Republic); Turcan & Turcan (Moldova); Mahoney and Lynch (Mongolia); Vujacic Law Firm (Montenegro) and Akhmedov, Aziz & Abdulhamidov, Attorneys (Tajikistan).


10. For example, the Polish Financial Supervisory Authority (formerly Polish Securities and Exchange Commission) is quite active and has taken several actions in reaction to (alleged) violations, including: withdrawal of intermediaries’ licences, suspension of share trading (in connection with breaches of disclosure obligations) and imposition of fines in connection with insider trading and market manipulation.

11. In Lithuania plaintiffs must prove not only that the financial information accompanying the prospectus contains a misleading statement but also that they relied on the prospectus and that their loss was caused by the misleading statement. In the Slovak Republic, under Article 121 of the Securities Act, the prospectus must state the person who is deemed responsible for the information included in it. To start a lawsuit, the plaintiff must demonstrate the tortuous act of the said responsible person, the damage caused by this tortuous act and the link between the tortuous act and the damage caused by it. In our hypothetical case study, these points are extremely complex to demonstrate.

12. For further reading on Moldova, see the article on Moldova in this issue of Law in transition, page 42.
Setting global standards for securities regulation
The International Organization of Securities Commissions (IOSCO) has established a set of principles for securities regulation, to ensure that markets are fair, orderly and transparent, that investors are protected and that systemic risk is reduced. This article discusses the rationale behind the principles, the methodology for their implementation and deficiencies in securities markets legislation that they are designed to tackle.

Setting standards in any field, but especially in the field of financial regulation, involves balancing the need to provide clear consistent guidance with the need to ensure that standards reflect contemporary approaches. If standards remain consistent over time, then they become a clear tangible goal to which people can aspire. While reform, particularly legislative reform, can be a slow process it can also be an evolutionary one, hence the value in consistency. Equally, the failure to respond to changes in regulatory best practice means that standards can become outdated and unhelpful.

IOSCO has established a set of 30 principles of securities regulation, which aims to ensure that markets are fair, orderly and transparent, to ensure that investors are protected, and to reduce systemic risk. The principles have been recognised as the international benchmark for securities regulation.¹

The IOSCO principles provide a consistent benchmark against which governments and regulators can gauge the effectiveness of their securities regulation. They are a good source of inspiration for legal reforms in many countries in the EBRD region.

IOSCO’s approach to securities regulation

IOSCO has a long history of working collaboratively on globally acceptable standards of securities regulation. However a series of market events, including the Asian financial crisis in 1997, illustrated to IOSCO and other international organisations the importance of a robust regulatory structure to maintain market stability. IOSCO therefore decided it was important to collect together in one document all of the standards relevant to the field. The principles were developed, taking into account previously published IOSCO reports, and were adopted by IOSCO’s President’s Committee in 1998.

IOSCO has endorsed the following three core objectives of securities regulation:

- investor protection
- ensuring fair, efficient and transparent markets
- reducing systemic risk.

The principles have been devised to meet these objectives and are designed to:

- incorporate the intentions underlying IOSCO reports
- provide for high-level objectives
- be non-prescriptive (that is, the focus is on the regulatory outcome desired, rather than the particular method of achieving that outcome).

The principles are structured around the following themes:

- the regulator (including accountability and independence, general powers and resources) (principles 1-5)
- self-regulation (principles 6 and 7)
- enforcement and cooperation powers (principles 8-13)
- issuers (principles 14-16)
- collective investment schemes (principles 17-20)
- market intermediaries (principles 21-24)
- secondary markets (principles 25-29)
- clearing and settlement (principle 30).
By applying the methodology to the regulatory structure in place in a jurisdiction, one can quickly and accurately identify any areas where the regulatory structure does not meet the IOSCO benchmark.

IOSCO also adopted a methodology in 2003, which was designed as a practical tool to help IOSCO members to implement the principles. Furthermore, external assessors can apply the methodology as a means of gauging the level of implementation by IOSCO members. The structure of the methodology is as follows:

- **key issues:** explain why a given principle is important
- **key questions:** focus on identifying whether the material aspects of the principle are being met
- **benchmarks:** sort responses into four categories, namely whether principles are:
  - fully implemented
  - broadly implemented
  - partly implemented
  - not implemented.

As a result, the methodology is currently being applied by:

- the International Monetary Fund and the World Bank through their Financial Sector Assessment Programme (FSAP)
- IOSCO members undertaking an IOSCO Assisted Assessment coordinated through the IOSCO General Secretariat.

### International Monetary Fund report on FSAP process

The International Monetary Fund (IMF) has recently published on its website a working paper entitled *Strengths and Weaknesses in Securities Markets Regulation: A Global Analysis* (November 2007). This working paper analyses the outcomes of the FSAP and Offshore Financial Centre Programme assessments undertaken between 1999 and September 2007, focusing on the level of implementation of the IOSCO principles according to the benchmarks set out by the methodology. While a number of these assessments pre-dated the publication of the detailed methodology, the paper provides a useful summary of those parts of the principles that show higher and lower levels of implementation globally. The IMF report analyses a series of countries including 15 of the EBRD’s countries of operations.

### General findings of the IMF report

In its assessment of regulatory systems, the IMF report notes that a recurrent theme is the inability of regulators to enforce compliance with existing rules and regulations. This systemic weakness appears, in most cases, to be the result of a combination of factors, namely the lack of independence of the regulator from the government and political processes, a lack of legal authority and deficiencies in both skilled personnel and resources. The report notes further that where more complex issues are confronted by regulators, such as asset valuation, risk management practices and internal control requirements for market participants and trading systems, these problems become more pronounced.

In statistical terms, the report shows that for the majority of countries, full implementation of the principles remains a challenging prospect. Only four principles (1, 4, 5 and 21) show levels of implementation of 80 per cent or above. Of greater concern are principles 2, 3, 10, and 24, for which the levels of implementation are below 50 per cent. These principles deal respectively with the independence of the regulator; its powers, resources and the capacity to perform its functions and exercise its powers; the effectiveness of supervision; and the existence of procedures for dealing with the failure of market intermediaries in order to contain systemic risk. The recent assessment on the quality of securities markets legislation in the EBRD’s region confirms the IMF’s concerns.
The authors also noted a high correlation between a country’s income and the level of implementation of the principles – specifically, the level of implementation increases in line with the country’s level of income. For example, countries with low income levels show implementation below 50 per cent; countries with middle income levels show implementation at 50 to 60 per cent; while countries with high income levels show implementation of above 70 per cent. This conclusion is also mirrored in geographical terms, as countries in higher income areas – such as Europe and Asia – demonstrate the highest levels of implementation, while areas of the world with lower average incomes – such as Central Asia, the Middle East and Africa – exhibit lower levels of implementation.

Relative strengths in securities regulation

A key strength identified by the report relates to the transparency of the regulator’s actions, with over 80 per cent of countries assessed achieving a grade of fully or broadly implemented on principle 4. The report notes that the majority of countries provided for equal access by all market participants to pre-trade bids and offers, as well as immediate post-trade reporting on exchanges. This was complemented by a similarly high level of implementation of principle 5, which relates to the standards of conduct of regulatory staff. There was also a high level of implementation of the principles relevant to the regulation of collective investment schemes (CIS), with each principle recording a result of over 50 per cent in the fully implemented category. Of particular note was the consistent implementation across most countries of adequate regulations concerning the form and structure of CIS. However, the report also noted that many countries had only fledgling CIS industries. It pointed out that this was likely to be a fast-growing area in the near future, highlighting the need for comprehensive licensing requirements and sufficient regulation.

In relation to the regulation of market intermediaries, many countries had in place adequate licensing criteria and licensing processes designed to mandate minimum entry standards for a variety of market participants. The relevant principle (21) shows a fully implemented rate of nearly 70 per cent. However, the IMF report found that, in general, the regulation of market intermediaries was an area of weakness in securities regulation. This was mainly due to a lack of capital adequacy requirements in many countries, combined with a dearth of appropriate risk management procedures for this group of market participants.

Disclosure regimes were assessed as adequate in most jurisdictions, even though less than 50 per cent of countries had fully implemented the relevant principle (14). The IMF report noted that, in most cases, prospectuses (including audited financial statements) were required to be given to investors prior to a purchase offer being accepted. At the same time, however, the IMF report noted that this relative regulatory strength was tempered by the fact that, in many jurisdictions, there was inadequate review of disclosure, and many regulators lacked skill in ensuring that disclosure was meaningful to investors.

Deficiencies in securities regulation

In summary, the key deficiencies in securities regulation identified by the IMF report were:
- weaknesses in supervisory practices, including inspections
- weaknesses in the enforcement of securities regulation
- inadequate valuation rules for investment funds
- a lack of understanding of risk management and internal control practices by market participants.

Key among these deficiencies is the lack of implementation of the principles related to enforcement of rules and regulations (principles 8-10). This generally stemmed from a lack of legislative authority to enforce the securities regulations, in particular a lack of investigative and surveillance powers.

These issues were compounded by problems in imposing sanctions, as some countries lacked the ability to impose administrative sanctions and thus had to rely solely on criminal authorities to remedy breaches of the law.

Furthermore, many of the jurisdictions that had the ability to impose administrative sanctions were hamstrung by the lack of severity in these penalties. This was mainly due to a lack of skilled personnel to undertake the necessary supervisory and enforcement actions.
The IMF report also noted that problems with enforcement in many jurisdictions are linked to the poor quality and ineffectiveness of the judiciary, although the requirement of an effective judiciary to supplement the enforcement of securities regulations is not explicitly addressed in the principles.

The IMF report revealed a low level of implementation of principle 2, which provides that the regulator should be independent from government control. The report demonstrates that less than 50 per cent of countries assessed achieved either the ‘implemented’ or ‘broadly implemented’ benchmark, which suggests that an inappropriate level of government control is being exerted over the operation of securities regulators. Conversely, this statistic demonstrates a sufficient level of regulator accountability to the government.

The principles relating to cooperation in regulation (11-13) also demonstrate lower levels of implementation, suggesting continuing difficulties in the sharing of information between both domestic and foreign bodies responsible for financial market regulation. The report noted that in some countries, at the domestic level, sharing of information between regulatory bodies was still only occurring on an informal basis. Similarly, several limitations still exist that hinder the efficient sharing of information between foreign regulators, and these appear to be largely based on a lack of authority to share various classes of documents.

**The IMF report and IOSCO**

The IMF report clearly indicates that some principles are implemented more effectively than others. For some principles a low level of implementation is evident in both developed and developing jurisdictions.

The findings of the report do not form a sufficient basis for amending the principles. The principles to some extent reflect best practice and there are countries for whom particular principles are aspirational. It is not in IOSCO’s interest (or that of its members) to lower standards in order to improve the level of implementation.

However, the report does clearly indicate to IOSCO the areas where it needs to do more to support and facilitate the implementation of the principles. In order to achieve this goal, the IOSCO Secretariat submitted a draft action plan to the IOSCO Executive Committee in April 2007, which suggested ways that IOSCO could facilitate implementation of the principles. The key elements of this action plan included:

- raising awareness of the principles;
- identifying requests for technical assistance
- increasing the number of assessors
- identifying country gaps and matching priorities with IOSCO planning
- coordinating all IOSCO actions.

IOSCO has also established its own programme of assisted assessments against the principles. The IOSCO Assisted Assessment Programme includes the development of an action plan in participating countries to enable them to overcome identified deficiencies.

Furthermore, IOSCO has recognised the importance of its regional committees in promoting the implementation of the principles and facilitating their adoption by all IOSCO members. To aid this process, presentations on the principles and the benefits of undertaking an assessment against the methodology are being given at each regional committee meeting in 2007 and 2008. Because jurisdictions in a particular locality often share linguistic, cultural, legal or economic ties, the regional committees are in a unique position to provide encouragement and technical support to jurisdictions wishing to undertake an assessment.
Conclusion

The IOSCO principles are the internationally-recognised benchmark for securities regulation. The methodology for assessing implementation of the principles is a powerful diagnostic tool by which gaps or weaknesses in a jurisdiction’s regulatory arrangements can be identified and rectified. Experience with assessing the implementation of the principles has suggested some common areas where securities regulation can be improved in practice. IOSCO remains committed to serving the needs of its members, to foster information exchange between them, to develop action plans to identify and rectify weaknesses in members’ regulatory arrangements, and to provide assistance in meeting their regulatory mandates.

Notes


3 See the article “Securities markets legislation in transition countries” by Gian Piero Cigna and Roman Chapaev on page 6 of this issue of Law in transition.

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The legal environment for asset-backed securitisation in Russia
Securitisation is a form of off-balance sheet financing that is increasingly being used in the EBRD’s countries of operations. Securitisation is significant not only as a financing tool, but also as an engine for change in economies that are seeking to modernise their infrastructure. This article reviews the development of the securitisation market in Russia, the efforts that have been made to improve the legal framework, and the challenges that still remain.

What is securitisation?
For all its complexities, securitisation is in essence a kind of secured lending. In its simplest form, it involves an asset originator (a bank, corporation or public sector entity) securing funding or capital relief by moving assets off its balance sheet in a true sale transfer to a bankruptcy remote special purpose vehicle (SPV). In turn, the SPV uses these assets as security for notes it issues to fund its asset purchase. Hence the assets come to be “securitised”.

Securitisation can be very advantageous for the originator. For example, it limits the originator’s risk exposure in the transferred assets to any credit enhancement it may provide in the transaction. Where the originator is a bank, this can mean significant regulatory capital relief.

Yet, it also allows the originator to extract profits periodically from the transferred assets in the form of cash in excess of the SPV’s needs. Securitisation permits the originator to diversify its funding sources, away from bank loans (in the case of corporations) and depositors (in the case of banks), through greater access to the capital markets. This can reduce the originator’s costs by allowing funding on the basis of the higher-rated debt issued by the SPV, compared with the originator’s own debt rating (see Chart 1).

Securitisation can be equally useful to investors and borrowers. The flip side of the originator’s access to capital markets is the investors’ access to new classes of assets (such as mortgage loans) and (indirect) exposure to the credit of companies that might otherwise not be available to them. From a macro perspective, this can mean deeper and more liquid markets, with more issuers, investors, tradable instruments, assets, and names than might otherwise be the case. From the borrowers’ perspective, cheaper funding for lenders should mean cheaper loans.

The case for reform
Not surprisingly, therefore, the establishment of a thriving securitisation market is often quite high in the planning priorities of emerging market economies. For securitisation is significant not only as a financing tool, but also as an engine for change in economies that are seeking to modernise their legal and market infrastructure. Given its complexities, an environment safe for securitisation generally presupposes, among other things, a relatively informed, transparent, flexible and integrated legal environment, which for many emerging economies means a programme of comprehensive reform.

Russia is one such country. Recently resurgent, the Russian economy has attracted much attention from the securitisation industry. In fact, the Russian debut in the securitisation market has been remarkable. The first Russian securitisation was launched in 2005 when the total volume of securitisation in Russia was US$ 200 million. This grew to US$ 3.4 billion in 2006 and at the end of June 2007 stood at US$ 1.9 billion, with the expectation (prior to the recent market difficulties) of exceeding US$ 5 billion by the end of the year. This increase has been matched by the growth in the types of asset classes being securitised which now include residential mortgages, consumer loans, lease receivables and future flows.

This growth in securitisation has been fuelled largely by Russia’s need to finance its rapid increase in consumer and mortgage lending in recent years.
However, this may be just the tip of the iceberg, as the amount of consumer and mortgage lending in Russia remains comparatively small.

As of July 2005, the Russian mortgage market had a ratio of housing-related debt (including mortgage loans) to GDP of just 3.3 per cent compared with housing-related debt-to-GDP ratios in Poland, the Czech Republic and Estonia of 5.5 per cent, 7.6 per cent and 16.6 per cent respectively. Comparable ratios in western Europe were even higher, at 52.4 per cent in Germany and 72.5 per cent in the United Kingdom. This, combined with a target of one-third of Russians owning their homes by 2010, is likely to mean that Russian securitisation will need to grow substantially to meet expected demand. The question is whether this can happen without a comprehensive reform of the legal system.

This is certainly possible. As the last few years have shown, investors sometimes ignore risks where caution may be warranted. The rapid growth of Russian securitisation in the face of heavily qualified legal opinions is testament to that. Nevertheless, experts have continued to point to the uncertainties in the Russian legal system as a constraint on the securitisation market and the billions of dollars of deals that have now been completed in Russia may themselves be reason enough for urgent reform.

The recent global liquidity crisis has again shown the nervousness of investors who are increasingly looking for transparency in financing structures. It could take just a few “bad” court decisions in Russia, for example, in respect of enforcing security or repudiating a true sale, for investors to lose confidence. Once investor confidence is lost, it may be hard to regain easily.

Legal uncertainties that affect securitisation in Russia

A comprehensive analysis in 2005 identified a number of legal impediments to the effectiveness of securitisation in Russia. More than two years later, much of that uncertainty remains.

The following is a summary of some of the important shortcomings in the Russian legal environment affecting securitisation.

Eligibility of receivables

Russian law requires that to be assignable, assets must be identified (rather than just identifiable). It prohibits the assignment of future receivables and does not permit assignments prohibited by the underlying contract.

This limits the assets available for securitisation. In contrast, these restrictions do not apply to factoring transactions. However, factoring only covers claims arising from delivery of goods, rendering of services or performance of works and does not include financial receivables.
Uncertainty of true sale

To protect against the originator’s insolvency, the assignment of assets to the SPV must constitute a true sale. Although Russian law permits parties to choose their transaction structures, a true sale may not occur in practice because:

- Russian courts are reluctant to enforce non-traditional financing structures (such as securitisation) and may re-characterise the sale as a secured loan.
- There is considerable risk (for up to three years after the sale) of a claw-back of the assets, as the originator’s insolvency administrator has the authority to cherry-pick the contracts to perform and may repudiate the asset assignment if either party has not fully performed its obligations.

Bankruptcy remoteness

It is critical in securitisation that the SPV is bankruptcy remote, that is, sufficiently ring-fenced so that it is neither implicated in the insolvency of the originator nor threatened by its own creditors. This entails limiting the SPV’s capacity to engage in business or incur debt, other than the notes in question, and obtaining non-petition and limited recourse covenants from its note holders and other parties to the securitisation.

As the non-petition and limited recourse options are not available even under the MBS Law, Russian SPVs are not considered bankruptcy remote and may require additional structuring to meet rating agency requirements in this regard.27

Additionally, with respect to hedging the SPV’s exposure to adverse currency and interest rates movements, it is doubtful whether standard arrangements (such as non-deliverable hedging contracts) are enforceable without the participation of a financial institution licensed in Russia.

Commingling risk

There is a risk for the SPV that proceeds collected on its behalf may be lost in the servicer’s insolvency. To prevent this, proceeds are usually held by the servicer in trust for the SPV and pledged to the note trustee. However, neither option may be available under Russian law which does not recognise the concept of trust and may not recognise the validity of pledges of bank accounts.

Market standard onshore SPVs

The SPV is fundamental to standard securitisation structures. It purchases the assets from the originator and issues the notes to securitise them. In securitisation-friendly jurisdictions, it should be simple to set up such an entity, limited to holding the assets and performing minimal tasks relating solely to the securitisation. To avoid the risk of consolidation with the originator or other entities in the transaction, these entities are often owned by a charitable trust.

However, this is difficult to do under Russian law which does not recognise the concept of “trust”. It is also unclear whether a non-commercial entity, with limited functions, can be set up in Russia other than under the special law relating to mortgage-backed securities (the MBS Law).16

Unavailability of certain standard credit enhancement mechanisms

A tranched issuance structure is a common form of credit enhancement, whereby subordinated notes provide credit protection to senior note holders. Although there have been tranched offerings under the MBS Law, this is generally difficult under Russian law because, upon enforcement of the SPV’s security, all note holders would rank equally as secured creditors. Also, Russian courts may read the civil code’s definition of a bond to imply the subordinated note holder’s right to repayment of principal and interest, regardless of the prior rights of the senior notes.

The Russian tax code

While not considered unfriendly to securitisation, the Russian tax code contains ambiguities that can adversely affect a transaction. As there is no concept of future assets in the tax code, an originator may be subject to a profit tax on the full amount of the sale price of the assets, as there would be no book value for future assets that may be deducted for tax determination.

Additionally, a profit tax is chargeable on any amount of interest the SPV receives in excess of the interest it pays out on the notes. Even an offshore SPV may be subject to such a tax if its activities in Russia constitute a permanent establishment, which is possible if it uses a Russian servicer.18
The Russian insolvency law

Russia is considered by many as not a sufficiently creditor-friendly jurisdiction. Secured creditors face uncertainty with respect to perfection of their security interest in assets, foreclosure on collateral in a timely manner and the predictability of priorities of payment during liquidation. Debt recoveries for creditors can be eroded by significant priority claims (such as labour claims and the claims of private customers, in the case of banks) and by long delays in the insolvency process. This is aggravated by the ability of the government and other interested parties to exercise influence over proceedings to the detriment of creditors. More specifically:

- The liquidator or administrator in insolvency may apply to invalidate a transaction (for example, the sale of assets to the SPV) on a number of grounds, including “undervalue” and “preferential satisfaction”, terms that are either vague or not defined in legislation.
- The liquidator or administrator may also repudiate the asset purchase agreement if it has not been fully performed, as well as other loss-making contracts of the originator.
- Russian courts do not permit segregation of funds in insolvency, giving rise to commingling losses for the SPV.
- Close-out netting provisions which are standard in the International Swaps and Derivatives Association (ISDA) documented derivatives transactions may not be enforceable under current insolvency laws.
- On the administrator’s application, regulators may approve a moratorium on payments from the originator which would affect its ability to transfer funds to the SPV under the servicing agreement.
- Creditors cannot (through non-petition and limited-recourse covenants) give up certain rights against the SPV.

Taking security

Russian laws governing security interests in assets are in need of updating. Currently:

- The validity of pledges of bank accounts is doubtful under Russian law. This means that a Russian SPV may not be able give enforceable security over its bank accounts for the benefit of investors.
- There is no form of security under Russian law that conveys title to the creditor in the event of a default. The only way to enforce a pledge or mortgage is through a public auction which needs to be court-authorised in the case of immovable property.
- The enforcement process is time-consuming and considered debtor-friendly. A court may refuse to enforce a pledge or may postpone the sale of assets for one year at the debtor’s request. The civil code does not provide guidance on how the court should exercise its discretion.

Reforms of the current laws on taking security are now under consideration.

The reforms

The response of Russian lawmakers to these uncertainties and impediments has been encouraging. Since 2005, various reform initiatives have been launched in Russia, some more successfully than others. They are as follows:

Law on mortgage-backed securities

Federal Law 152-FZ on Mortgage-Backed Securities was adopted in November 2003 and became operational in July 2006. It allows for the issuance of two types of mortgage-backed securities, namely mortgage-backed bonds (MBBs), which may be issued by banks and SPVs, and mortgage participation certificates (MPCs), which may be issued by banks, licensed investment companies, unit investment funds and private pension funds. MBBs are debt instruments secured by a pool of mortgage loans and require registration with the Russian Federal Service for Financial Markets (FSFM), Russia’s principal securities regulator. However, MPCs are more like units in a mutual fund. They do not have a nominal value and represent an undivided interest in the mortgage pool.

The MBS Law introduced certain new concepts in Russia, including that of an onshore securitisation SPV (or mortgage agent). However, so far, there has been only limited use of such entities, in part because some of the broader issues affecting securitisation remain unaddressed:

- Even under the MBS Law, a Russian SPV is not considered bankruptcy remote without additional structuring to ring-fence its assets (see above).
Concerns remain regarding the validity of true sales in the event of the originator’s insolvency.

Concerns remain about commingling losses in the absence of the segregation of servicing proceeds and the ability to pledge bank accounts.

In short, even the MBS Law has failed to devise necessary safe havens for practitioners that could put these and other issues beyond doubt. Hence, while it has recently been used to complete some high profile transactions, the MBS Law itself remains in need of adjustment.

**The 2006 draft laws**

In 2006, the FSFM prepared a number of laws that were intended to facilitate securitisation in Russia. They provided for changes to existing laws, including the Russian civil code, the insolvency law, the securities law, the banking law and the Russian tax code, to deal with some of the issues discussed above. In summary, the 2006 draft laws propose:

- Setting up a special finance company (SFC), in the mould of an international SPV, with a limited purpose, no employees and other attributes of bankruptcy remoteness such as protection from insolvency.
- Changing the laws regulating the pledge of receivables designed to allow (among other things) the pledge of future receivables as well as a part of a receivable (rather than necessarily the whole of it), identification of a receivable by generic description in the pledge agreement and the enforcement of the pledge through operation of the pledge agreement or operation of law (court proceedings) rather than a public auction.
- Setting up two new types of accounts that would help in the securitisation context: a pledge account, and a nominal account designed, respectively, to deal with the current restrictions on pledges of bank accounts (the pledge account could be pledged) and to allow the segregation/protection of third party funds in the case of the insolvency of the servicer, to deal with the commingling risk (funds in the nominal account would not be included in the insolvency estate of the bank).
- Amending the Russian tax code to support the activities of the SFC.

However, these draft laws have not yet been enacted.

**Currency restrictions**

In the past there were significant currency restrictions in Russia which, while not directly affecting the structure of transactions, made them more expensive. Limited reform came in the form of the 2004 Law on Currency Regulation. While removing the need for individual authorisations for transactions, this set up a new regime of special accounts through which affected transactions would be effected. It also set up mandatory reserving, requiring market participants to deposit specified amounts with the central bank for specified periods in respect of transactions with securities, loans, imports and fund transfers.

While it was left to regulators to decide whether to introduce these regulations, the very possibility was a source of uncertainty. For, if imposed, the restrictions would have made purchases more expensive for both foreign investors (in bonds issued by Russian SPVs) and for Russian investors (in bonds issued by foreign SPVs).

However, in 2006, the requirements for special accounts and reserving were abolished. This is a welcome sign of the Russian government’s continuing interest in market reform. While certain currency restrictions remain, these are not seen as particularly onerous for the securitisation market.

**Derivatives regulation**

A standardised and transparent derivatives market is essential for securitisation to work, as securitisation involves converting cash in-flows of a certain periodicity, currency and interest rate into out-flows of a different periodicity, currency and/or interest rate. Such a market has been difficult to develop in Russia.

Following the financial crisis of 1998, Russian courts held that non-deliverable forward foreign exchange transactions should be considered as gambling/wagering contracts under Article 1602 of the Russian Civil Code and hence unenforceable. Consequently, cash-settled derivatives that did not envisage physical delivery of the underlying assets were at risk of being unenforceable. This may have been reason enough not to locate an SPV in Russia, as it would have found it difficult to hedge itself.

However, there are other problems as well. Standardised close-out netting provisions in derivative contracts may be unenforceable under Russian insolvency legislation as they could be classed as a prohibited set-off between a creditor and an insolvent company.

Although the wagering concern has abated somewhat with the recent amendment to Article 1602 (which exempts transactions that are cash settled rather than deliverable contracts), the exemption is quite limited and applies only to transactions to which licensed financial institutions are party.
This excludes a number of non-financial institutions that may use such products. Also, it is likely that the licensing requirement limits the exemption to financial institutions holding a licence in Russia.

With respect to close-out netting, there is currently legislation planned to amend the Russian insolvency law for credit organisations (see below) by limiting the powers of the counterparty’s insolvency administrator to cherry-pick transactions for repudiation and by distinguishing close-out netting from other, prohibited forms of set-off. While this would bring the Russian derivatives market closer to the international norm, unfortunately, in its current form, the proposed amendment is limited to financial institutions as counterparties and to master agreements that meet the criteria to be specified in the proposed legislation. Once again, the propensity to over-regulate threatens to detract from an otherwise useful reform.

Proposed amendment to the law governing the insolvency of credit organisations

The Committee of the State Duma on Credit Organisations and Financial Markets in Russia is currently reviewing a draft law that would amend Federal Law No. 40-FZ, relating to the insolvency of credit organisations. Its stated purpose is to:

- specify the qualifications for an eligible master agreement (to permit close-out netting) and amend the Russian insolvency law to allow enforcement of close-out netting against an insolvent counterparty
- facilitate securitisation through regulations aimed at addressing issues such as re-characterisation risks and commingling risks arising out of the insolvency of the originator and/or servicer of the assets transferred to the SPV.

The proposed law would introduce the concept of “servicing claims” and means to exclude the funds related to such claims from the bankruptcy estate of the servicer. It seeks to formalise procedures for assigning such claims to a third party in the case of the servicer’s insolvency, as well as to shorten the period and reduce the reasons for voiding contracts that the administrator may use to repudiate its obligations to the SPV.

While generally viewed in a positive light, these reforms are seen as falling short of the measures required.

In addition to the limitations noted regarding close-out netting, the uncertainties and issues that the present initiative fails to address are at least as important as those it seeks to affect. For instance, there is no mention of non-petition clauses and limited recourse covenants which would go a long way to addressing the uncertainty regarding the bankruptcy remoteness of Russian SPVs. There is also no mention of a framework for Russian SPVs outside the MBS Law, whereas the list of asset classes securitised in Russia has grown to include assets other than mortgage loans.

Additionally, the initiative is too narrowly cast. It is limited to the issue of insolvency, when other areas of the law, for example the MBS Law and parts of the Russian civil code, also need attention. Also, it only addresses the insolvency of credit organisations.

Clearly, securitisation is also important to the non-financial sector in Russia and the reforms should therefore also address the general insolvency law.

Conclusion

Notwithstanding the successes of the past two years, uncertainties still dog the Russian legal environment so far as securitisation is concerned. There is no denying that the efforts to reform made so far have yielded notable (albeit limited) successes, such as the MBS Law. However, a significant amount of work still needs to be done if early successes are to be sustained.

Given the current market dynamics and the period of caution that is likely to follow, it may be too much to hope that, as the Russian legal system now provides the basic regulatory framework for securitisation, occasional reforms in specific areas or ad hoc solutions to specific bottlenecks will be sufficient for securitisation to flourish. A more comprehensive and integrated approach is necessary. The recent spate of reform initiatives and proactive solicitation of market opinions indicates that Russian law makers may be listening.
Notes

1 The term has different meanings depending on the context but is most often used to determine whether the transfer of assets to the SPV successfully removes them from the originator for insolvency purposes.

2 Bankruptcy remoteness means securing the SPV from the insolvency of the originator, as well as from any action in respect of insolvency or reorganisation of the SPV itself.

3 For example the originator may retain the equity tranche in a transaction or provide the SPV with a subordinated loan facility as a credit enhancement to support the senior notes.

4 The US$ 49.8 million auto loan securitisation by Bank Sosyuz, which closed in August 2005.


6 See note 5.

7 See note 5.

8 See note 5.


17 In a recent Russian RMBS transaction, in which the EBRD was a mezzanine investor, calculation of the interest due on the mezzanine and junior notes and the rights of the noteholders had to be restructured to make the SPV “bankruptcy remote”.


20 This and certain other problems with the current insolvency law in Russia (including difficulties in enforcing close-out netting in derivatives contracts) are being addressed in the recently proposed draft law that would amend Federal Law No. 40-FZ, relating to the insolvency of credit organisations.


27 Federal Law No. 40-FZ on Insolvency (Bankruptcy) of Credit Organisations (February 25 1999).

28 Federal Law No.5-FZ (January 26, 2007).

29 Explanatory Note to the Draft Federal Law on Amendments to the Federal Law on Insolvency (Bankruptcy) of Credit Organization.

30 Federal Law 127-FZ on Insolvency (Bankruptcy) (October 26, 2002).

31 The Supreme Arbitration Court of the Russian Federation (SAC) has recently issued Information Letter No. 100 (an overview of court practice) under which it has expressed a clear position on the application and interpretation of various provisions of Chapter 24 of the Russian Civil Code concerning the assignment of rights. This includes the clarification of several points of uncertainty (for example partial assignment of contractual claims) which had previously warranted material qualifications to the Russian law true-sale opinions delivered in the securitisation market and also the provision of significant new comfort in relation to the feasibility of securitising Russian law receivables on a future-flow basis. Although there is no concept of judicial precedent under Russian law and SAC information letters or resolutions do not constitute a source of Russian law, the lower courts in Russia are required to have regard for SAC decisions. (Information taken from an Allen & Overy e-Bulletin, 4 February 2008.)

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United Kingdom
The Albanian Financial Supervisory Authority: an integrated regulator for the non-banking financial sector
The Albanian Financial Supervisory Authority (AFSA) was established in October 2006 as part of the Albanian government’s moves to reform the regulatory system for the country’s non-banking financial sector. So there are now two financial regulators in Albania: the AFSA and the Bank of Albania, which regulates the banking sector. At some point, the anticipated developments within Albania’s financial sector may require the creation of a single financial regulator.

The AFSA regulates insurance, securities, and private pensions. The World Bank has helped in compiling the unification strategy for insurance, pensions and securities markets supervision, and in establishing the AFSA as an independent integrated regulator, by evaluating the institutional and staff capacities, and defining the primary objectives of the new institution. The horizontal approach of integration has been applied to the AFSA’s structure, with its organisation being built according to its main functions, such as legal, on- and off-site supervision, licensing, monitoring and administration. Among the key benefits of unification are: the creation of equivalent and harmonised regulation and standards across different areas of the financial sector; the synergy between functional areas, from the point of view of either personnel or regulatory impartiality; and a better facilitating of international cooperation.

The main mission of the AFSA is customer protection, closely linked with the sound development of the non-banking financial markets in Albania.

The AFSA is a full member of the international associations of regulators in the areas of insurance, pensions and securities, ensuring that standards of regulation meet international requirements.

The non-banking financial sector

The markets regulated by the AFSA fall into three major groups: insurance, securities and supplementary private pensions (pillar III).

The insurance market

Most of the efforts of the AFSA are concentrated on the insurance market. The insurance market is the second most important financial sector in Albania after banking, with total assets of €91 million, or around 10 per cent of the total assets of financial markets in the country.

There are currently 10 licensed insurers in Albania, seven of which deal in non-life insurance, two in life insurance, and one in both life and non-life insurance. The largest Albanian insurers, Sigal, Insig and Sigma, have successfully expanded their non-life insurance operations in the region through their subsidiaries in the Former Yugoslav Republic of Macedonia (FYR Macedonia) and Kosovo. A smaller insurer, Albsig, has also recently expanded its operations in FYR Macedonia.

The industry’s gross written premiums (GWP) in 2006 were around €36 million, which represents only 0.5 per cent of the country’s GDP (see Chart 1 on page 34).

According to the AFSA’s monthly statistical report, the 2007 figures show a positive development for the insurance market. Ten-month premiums have increased by 36 per cent compared with the respective period in 2006, while expectations for the year-end figure are even more optimistic.

Compulsory motor insurance continues to dominate the market (see Chart 2 on page 34), but this dominance is threatened by the recent rapid growth in non-compulsory products. The market growth in 2007 looks promising when compared with the 12 per cent growth rate in 2006 and annual average growth rates of 4.5 per cent in the last four years. However, even though 2007 growth rates are good, the Albanian insurance market is still small compared with its potential.

The Albanian insurance market is developing along similar lines to those of other south-eastern European economies. The growth of different sectors in the Albanian economy is creating enormous opportunities for insurance policies, especially in the areas of construction, life and health...
### Table 1
Financial system supervisory and regulatory structure in Albania

<table>
<thead>
<tr>
<th>Accountability</th>
<th>Regulators</th>
<th>Fields</th>
<th>Market operators</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Parliament</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Financial Supervisory Authority</td>
<td>Private pensions market</td>
<td>Supplementary private pensions institutes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Securities market</td>
<td>Investment advisers, Securities registers, Securities business intermediaries, Securities markets</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Insurance market</td>
<td>Insurance service suppliers, Insurance business intermediaries, Insurance companies</td>
</tr>
<tr>
<td><strong>Bank of Albania</strong></td>
<td>Other institutions</td>
<td>Other financial institutions</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Foreign exchange offices</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Universal banks</td>
<td></td>
</tr>
</tbody>
</table>

Source: Albanian Financial Supervisory Authority

### Chart 1
Development of the insurance market in Albania

![Development of the insurance market in Albania](image)

**Note:** 1999 marked the real liberalisation of the Albanian insurance market with the entrance of the two first private insurance companies, a process which continued in 2004 and later with other new players on both the life and non-life side. The rapid development experienced in the period 2003-05 was affected by the significant changes in the currency exchange rate, with strengthening of Albanian lek against the euro and US dollar. The trend of 2007 shows the real growth of the Albanian insurance market.

Source: Albanian Financial Supervisory Authority, 2007

### Chart 2
Structure of the Albanian insurance sector

![Structure of the Albanian insurance sector](image)

and natural disasters. However, market players have to become more aware of new insurance techniques and contemporary approaches related to insurance risk modelling, the complexity and nature of insurance products, the quality of statistics and data, educational and marketing policies and corporate governance.

The AFSA has dedicated significant resources to carrying out a detailed study of the insurance market, to identify the strengths and weaknesses of the developing sector. The AFSA monitors the financial indicators of insurance companies on a quarterly basis, in order to guarantee the solvency and healthy development of the sector. At the end of 2006, the AFSA implemented the Insurance Regulatory Information System (IRIS) tests on non-life insurance operations.¹ The introduction of such a standard was suggested and strongly supported by the World Bank, which also held a training session in Tirana on the necessity and use of the system.

Having reviewed IRIS tests and ratios for 2006 and 2007, the AFSA believes that much needs to be done to address the fact that most insurers in the market have a claims ratio below 50 per cent, and an expense ratio exceeding 50 per cent. The current situation proves that the profitability of insurers remains mostly linked with the low level of loss ratio, while other expenses are considerably high. The off-site analysis has been closely tied up with various on-site inspections and close monitoring of insurers’ operations, focused on the areas of underwriting, claims, accounting, corporate governance and on relations with shareholders.

### The securities market

The securities markets continue to be dominated by the trading of government debt instruments (T-bills and bonds) in the primary and secondary market, while the stock market remains undeveloped and limited to off-exchange market transactions. In recent years, various national and international entities have shown an increasing interest in operating in the securities market.

In 2006 there was a relatively strong number of transactions in the government securities retail market, which experienced significant growth compared with the previous year (see Table 2). The increase of public interest in investing in government securities boosted the volume of transactions. The AFSA has recently implemented a web-based platform in order to keep the public informed on the processes of quoting and transactions of government papers in the retail market. The new online system will track sales of securities and help to expand volumes on the secondary market. The AFSA’s activity in the securities markets has mainly focused on the permanent monitoring of market indicators and promoting the development of the market through completing the legal framework.
Private pension funds

In the supplementary private pensions area, there are three companies operating with a very limited number of contributors. The existing legislation on private pensions dates back to 1995, and it needs to be amended with adequate provisions in order to sustain a quick and safe development of the third pillar.2

The lack of large players or foreign companies in this market can be attributed to the limitations in the existing legal framework, the few fiscal incentives and the current low level of development in the capital markets. In line with the International Organisation of Pension Supervisors (IOPS) Principles of Private Pension Supervision,2 and EU directives, the AFSA is working to draft and adopt new legislation for private pensions and asset management. As with insurance, a risk-based approach will be applied, seeking to offset problems proactively before they arise, rather than reacting after the event.

Challenges of growth – the role of the AFSA

The recent development of Albania’s insurance, pensions and securities markets requires the adoption of advanced regulation and supervision in line with the best international standards and practices. It is a challenge for the AFSA to put in place and coordinate structures linked with the introduction of new laws or regulations, amendments in the current legal framework and the introduction of contemporary methods of supervision.

In order to comply with EU directives, there have been a number of changes in current laws and regulations.

In 2007, the Albanian parliament approved an increase, to €3 million, in the minimum capital of the insurance companies operating in Albania. In line with EU requirements, this level has to be reached by Albanian insurers in three stages, with the final stage reached by 31 March 2008. To date, all insurance companies have met the first two increases required for 2007.

By the end of 2008, Albanian insurance companies will have to present their accounts in compliance with International Financial Reporting Standards (IFRS). Accounting regulations will need to be amended to reflect the changes between the current system of accounting and the IFRS. As this will be a challenge for the insurance industry, the AFSA has organised a series of training sessions for sector representatives.

In the light of international best practice, by-laws and guidelines have been reviewed with regard to the minimum standards for the establishment of technical provisions, claims assessment, solvency, maintenance of acceptable financial records, increase in the quality of reinsurances and controls over reinsurance transactions and investments.

There is a need for change in the legal framework of compulsory motor insurance in order to improve the market structure. The role of the Albanian Insurance Bureau, a full member of the Council of Bureaux since 1992, needs to be better specified within the regulation, and the designation of clearer responsibilities between the market and regulator have to be established.

Table 2

<table>
<thead>
<tr>
<th>Type of transaction</th>
<th>Quarter 1</th>
<th>Quarter 2</th>
<th>Quarter 3</th>
<th>Quarter 4</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Nominal value (million lek)</td>
<td>Number of transactions</td>
<td>Nominal value (million lek)</td>
<td>Number of transactions</td>
</tr>
<tr>
<td>1. Purchase in the primary market</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individuals</td>
<td>2,058.93</td>
<td>992</td>
<td>756.97</td>
<td>272</td>
</tr>
<tr>
<td>Juristic persons</td>
<td>706.76</td>
<td>17</td>
<td>880.25</td>
<td>13</td>
</tr>
<tr>
<td>2. Selling from bank portfolio</td>
<td>2,891.33</td>
<td>1,445</td>
<td>725.61</td>
<td>305</td>
</tr>
<tr>
<td>3. Purchase from individuals prior to maturity date</td>
<td>115.34</td>
<td>74</td>
<td>227.53</td>
<td>138</td>
</tr>
<tr>
<td>4. Payment of nominal value in maturity date</td>
<td>209.36</td>
<td>48</td>
<td>814.77</td>
<td>78</td>
</tr>
<tr>
<td>5. Pledging of government securities as collateral</td>
<td>2.53</td>
<td>2</td>
<td>7.72</td>
<td>18</td>
</tr>
<tr>
<td>Total</td>
<td>5,984.25</td>
<td>2,578</td>
<td>3,412.85</td>
<td>824</td>
</tr>
</tbody>
</table>

Source: Albanian Financial Supervisory Authority, 2007
The AFSA is working closely with major international financial institutions and agencies like the World Bank, the EBRD and USAID in reviewing legislation, setting up risk-based supervision and implementing contemporary IT techniques.

A good example of the efforts to develop new channels was demonstrated this year, when the AFSA initiated and led the process of establishing the motor insurance data centre, in line with the requirements of EU directives. The new data centre aims to establish and promote transparent and standardised sales in motor third party liability products, thereby tackling the phenomena of price reduction and unfair competition from certain players. The centre will ensure fair competition, while also identifying uninsured vehicles and minimising their number. The inclusion of claims data within the motor data centre, to be developed at a later stage, will lead to the introduction of a risk-based rating system in motor insurance, replacing the current system of compulsory fixed minimum rates.

Among efforts to improve the legislation in the securities area, new legislation on corporate and municipal bonds has been proposed, and is being developed in cooperation with the EBRD. Further work relates to new legislation on collective investment schemes and asset management. The legal framework governing the private pension industry will also be reviewed and updated, in tandem with the AFSA’s ongoing work to develop a second public pillar for the Albanian pension sector.

As well as updating legislation, the AFSA is also working on establishing risk-based supervision for insurances and private pensions. This new approach towards supervision requires a contemporary methodology that needs to be supported by an electronic reporting and analysis system. This will ensure fast and reliable communication and improved analysing capacities, including crucial early warning notifications. The AFSA is working closely with major international financial institutions and agencies like the World Bank, the EBRD and USAID in reviewing legislation, setting up risk-based supervision and implementing contemporary IT techniques.

The EBRD, supported by the donors of the Western Balkans Fund, has already approved a project to develop a management information system (MIS) for the AFSA. The main objective of this assignment is to develop a suitable MIS to support the AFSA’s supervisory process. The assignment will enable the effective and orderly development of key areas of the non-banking financial institutions market, and specifically the insurance (life and non-life) and pension fund management sectors, by strengthening the AFSA’s capabilities through modernising its information and reporting system.

The AFSA’s main objectives will be to ensure the quality of financial products, combined with more efficient handling of claims and quick payments from insurers. The quality of governance is a key factor in the efficiency of financial companies, and improving this would improve their risk management and reduce the high administration costs that they are currently incurring.

The hardening of the supervisory regime comes with a cost for companies in the market. In view of this, the AFSA has planned to explore, along with the market, the opportunities for supportive measures that would enable the introduction of new financial products.

The AFSA, in close cooperation with the Association of Albanian Insurers, has worked to promote specific insurance products covering lines of business such as construction, mining, and public services. Albania is heavily exposed to the possibility of earthquakes and floods, and it is essential for the country to develop national schemes of protection against natural disasters, based on international experience. This remains a great challenge for the insurance sector.

Rapid development predicted

The AFSA is confident that the non-banking financial sector in Albania is about to expand extensively within a short period of time. The factors that will fuel this expansion, and that are attracting the interest of international investors, are the country’s solid macroeconomic performance, the recent exceptional trends in the banking sector, current progress in the supervision and regulatory regime and high growth potential in the financial markets.

There are rapid developments in the acquisitions of insurance companies. The vast majority of Sigma’s shares have been transferred to TBIH Financial Services Group, which is 60 per cent owned by Vienna Insurance Group, and the majority of Interalbanian’s shares have been sold to the Aspis Group from Greece. Also, Sigal, Albania’s largest insurer, has set up a dynamic
cooperation with the other leading Austrian insurer, Uniqa Group. Reputable international investors are negotiating with other local insurers, while there is active interest from leading international players in the full privatisation of INSIG, the national insurance company, which is due to be completed shortly.

The injection of international expertise and experience into the Albanian insurance market has already started to produce positive results through the launch of new insurance products, especially in the areas of life and health. The AFSA also expects there to be positive effects on corporate governance and quality of services.

The AFSA is convinced that it will achieve its goals through good planning and a proper allocation of resources, while maintaining a close cooperation and proper communication with the market players in the areas of insurance, private pensions and securities. This strategy will allow the AFSA to develop programmes that promote the efficiency and integrity of the supervised markets. In addition, educating consumers about financial matters will be part of a broad campaign that the AFSA will develop along with other financial institutions in Albania, aiming to make people aware that financial services are available and affordable.

Notes

1 The Insurance Regulatory Information System (IRIS) tests comprise a set of eleven financial ratios developed from financial information filed annually by most insurers to serve as an early warning system to identify problems and trends in financial solvency. When a financial ratio falls within the parameters designated by each IRIS test, it is designated as a “usual value”; those falling outside such parameters are designated “unusual values”.

2 A pillar is a particular component of a pension system. According to the World Bank, pension systems typically have between one and three pillars, each pillar distinguished by its financing methodology (PAYG or full-funding) and by its coverage (mandatory versus voluntary). The third pillar enables insured persons to build up their own personal capital as pension provision by contributing some portion of their wage to the voluntary accounts in the private pension funds if they are not satisfied with the mandatory state pension system.


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Setting up Kazakhstan’s first regional financial centre
This article discusses the setting up of Kazakhstan’s first regional financial centre in Almaty, evaluates its achievements so far in attracting international investor interest and looks at new directions that it must take in the future.

The President of Kazakhstan, Nursultan Nazarbaev, initiated the project for a regional financial centre in Almaty (RFCA), first raising the idea at a meeting with members of the Kazakhstan Banking Association in 1995, and referring to it again during an address to the Kazakhstan Financiers Congress in November 2004.

In 2005, the Kazakh government retained the Boston Consulting Group (BCG) to help with the implementation of the project. BCG had previously played a direct role in setting up and developing financial centres in Singapore and Thailand. Its main task was to analyse current progress and gaps in the development of Kazakhstan’s financial market, and to put forward recommendations concerning the legal, infrastructure and management aspects of the proposed financial centre.

On 5 June 2006, President Nazarbaev signed the Law on the Regional Financial Centre in Almaty. The centre is officially regulated by an agency whose status is that of a centralised body that is not part of the government, but is subordinate to the President of Kazakhstan and reports directly to him.

The agency’s main function is to exercise government powers with a view to developing the financial centre in particular and the stock market in general. Essentially, it is a government body that is responsible for coordinating the actions of the government, parliament, central and local executive authorities and the private sector in order to develop Kazakhstan’s securities market.

A council composed of leading national and international financial experts and representatives of Kazakh government organisations was created under the auspices of the agency. The principal objectives of the council are to develop recommendations on how to use international experience in areas relevant to the RFCA’s activities and to participate in the drafting of its development strategy.

The experience of countries that have set up financial centres indicates that the specialised nature of the relations that arise within a stock market demands a highly professional approach. For this reason, during the first few months, efforts to recruit staff proceeded in parallel with work on drawing up programme documents and resolving organisational and legal issues. This process is still continuing.

Key milestones

The agency conducted a series of official visits and signed memoranda of understanding and cooperation with a number of leading international stock exchanges, thereby preparing the ground for future dual listings, exchange of information and access to foreign experience in developing international centres. In these memoranda, the parties expressed their willingness to create mechanisms for long-term cooperation between the stock exchanges and the RFCA and to establish a system of regular meetings and information exchange between senior management. In order to attract investors and issuers, the parties agreed to hold joint conferences and presentations and to develop various programmes and documents to make their cooperation more effective.

A cooperation agreement was also signed between the agency and Kazinvest, the Kazakh investment promotion centre. The sides agreed to focus their joint efforts on doing more to attract foreign and domestic investors to the Kazakh economy and on creating a system to support the promotion and implementation of investment projects.
The agency has concluded memoranda of understanding and cooperation with the country’s leading higher educational institutions, namely the Ryskulov Kazakh Economics University and the Satpaev Kazakh Scientific and Technical University. Under these memoranda, lectures on the stock market for economics students and introductory seminars and presentations for students and lecturers are now being organised.

The agency has participated actively in international financial conferences held both in Kazakhstan and abroad. It has given presentations on the RFCA at these events, explaining the principles of its operation as well as the tax and other incentives available on the RFCA’s special trading area. At all meetings and events involving representatives of foreign financial institutions and state organisations, the agency makes every effort not only to market the RFCA and its development, but also to enhance the overall image of Kazakhstan. Information articles on Kazakhstan and its financial sector have featured in a number of foreign publications, such as the Financial Times, Institutional Investor, World Financial Review and the corporate journal OMX Market View.

In addition, the agency has organised its own events. For example, during the official visit of the Kazakh delegation to Singapore for the annual meetings of the International Monetary Fund and the World Bank, the agency, together with the Kazakhstan Financiers Association, organised an event with Kazakhstan as the theme. The event provided an opportunity for talks with representatives and directors of the Dubai International Foreign Exchange (DIFEX), Singapore Business Federation, Temasek holding company, Crédit Suisse, ABN Amro, Deutsche Bank AG London and Merrill Lynch.

In conjunction with the company Renaissance Capital, the agency organised conferences in Moscow and St Petersburg. Professional participants in the Russian stock market and large and medium-sized companies from the Commonwealth of Independent States (CIS) took part in these conferences, which stimulated considerable interest in the RFCA. Talks with the management of Russian stock exchanges were held during these conferences.

**Current challenges and future plans**

After only one year of operation, the agency has achieved considerable results. Unfortunately there remain a number of challenges that must be resolved if the RFCA is to attain the status of a competitive financial centre that meets international demands and standards.

**Developing the infrastructure of a financial centre**

The highest priority in terms of infrastructure development is to position Almaty as an international financial centre. This calls for the creation of a world-class infrastructure, which in turn presupposes the establishment not only of all the necessary elements that make up a stock market, but also of the infrastructure of a financial centre.

All the core elements of a stock market are already operating in Kazakhstan, but the state must put in place conditions for the issuance and trading of financial instruments that will give the new financial centre a clear competitive edge over leading stock exchanges. The attainment of these goals requires structural changes to existing financial institutions such as the stock exchange, the central depository and independent registrars. The agency has already introduced the necessary amendments to Kazakh legislation to permit the operation of the stock exchange as a commercial entity.

To create the conditions for the further development and operation of the RFCA with an infrastructure that meets international standards, there are plans to acquire a modern business centre that will house the offices of the agency, the stock exchange, the central depository, a special financial court and financial centre members.

In addition, the government must give more attention to attracting small and medium-sized companies to the stock market, something that will require a proper assessment of their creditworthiness. Since the scale of their activities is relatively small, retaining the services of international ratings agencies is not always financially feasible. Accordingly, there is a need to establish a national ratings agency in Kazakhstan, which will become an important part of the domestic securities market. The agency is already taking steps to set up such an organisation.

**Greater involvement of issuers**

Ensuring that issuers play a more active role in the stock market is a crucial factor in increasing the liquidity of the domestic market. The lack of issuers on the Kazakh securities markets is due to factors such as the high concentration of ownership or low level of free float on the stock market, the low level of participation of national companies in the domestic stock market, and the preference of Kazakh companies to be listed abroad.

There is a need to establish a national ratings agency in Kazakhstan, which will become an important part of the domestic securities market. The agency is already taking steps to set up such an organisation.
The agency has proposed a meeting of a working group at the Kazakhstan Financiers Association to discuss the question of launching Islamic financial instruments on the RFCA’s special trading area.

The agency is working to achieve this. For example, together with the administrations of all 14 regions of Kazakhstan and of Astana and Almaty, it has organised presentations by the RFCA and round table discussions with the aim of attracting potential issuers and investors to the RFCA and of setting out the advantages it offers. In connection with these events, the agency signed memoranda of understanding and cooperation with the administrations with the aim of working together to attract issuers to the RFCA’s special trading area and to educate the public in the fundamentals of investing.

The agency and the Russian company Renaissance Capital are jointly studying the possibility of bringing Russian and Ukrainian issuers to the RFCA. The agency is also taking steps to attract potential issuers from other CIS countries.

**Improving standard financial instruments and developing new ones**

A priority for the development of the stock market is to encourage greater market activity in standard financial instruments (shares and bonds) and to introduce new instruments such as asset-backed securities (ABS), real estate investment trusts (REITs), index funds (ETF), Islamic financial instruments (sukuk) and derivatives, which would help to increase the liquidity of the stock market substantially and to attract new participants. The agency has proposed a meeting of a working group at the Kazakhstan Financiers Association to discuss the question of launching Islamic financial instruments on the RFCA’s special trading area. Corporate bonds – which have lower disclosure requirements and do not affect ownership structures – are also attractive to financial market participants.

**Attracting domestic and foreign investors**

Institutions are the main investors in Kazakhstan. However, in order to create diversified, more profitable and less risky portfolios, there will need to be further development of their investment potential, changes in internal risk management requirements, provision of hedging opportunities and a review of investment rules aimed at easing requirements for investing in foreign financial instruments.

The successful development of the Kazakh stock market requires much greater involvement from individual investors, as a new and active class of investors would increase liquidity. Permitting government employees to buy securities would be a step in this direction. To facilitate this, the agency is proposing amendments to the Law on the Civil Service that would give government employees the right to purchase and trade securities.

**Raising public awareness of the investment world**

Although there is interest from the public in investing disposable income in alternative investment vehicles, public participation in the stock market is held back by a lack of trust arising from a poor knowledge of the market.

Consequently, in order to improve investment literacy and the financial culture of the public at large, the agency has arranged for special columns on the credit markets to be published in various central and regional media, featuring articles and analytical reviews prepared by agency staff and experts from companies that are professional participants in the RFCA. To date, over 200 articles have been published.

The agency plans to draw up and publish brochures and guides (stock market handbooks) which will be distributed free of charge at various institutions, companies and organisations. In addition, stock market information stands have been installed in centres that serve the public and in regional tax offices.

The agency also has plans to develop and implement, through the media, a series of educational programmes aimed at raising the level of investment literacy of the public. The agency is considering creating an educational web site as well as a specialist periodical that would provide financial and analytical reviews relating to the Kazakh and foreign securities markets. These measures should lead to an increase in the number of domestic and foreign investors, issuers and professional market participants on the Kazakh capital market.

In conclusion, financial centres today play a very special role in the development of a country’s economy. In this context, the activities of Kazakhstan’s financial centre constitute a major advantage for a nation that has set itself the goal of becoming one of the world’s top 50 most competitive countries.

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**Notes**

1. The free float refers to the total number of shares publicly owned and available for trading. It is calculated by subtracting restricted shares from outstanding shares.

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The perspectives of capital market development in Moldova
This article reflects on the latest amendments to company law and securities markets legislation in Moldova. It also describes the new role of the recently created single authority for non-banking financial services. Finally, it suggests some proposals for further development of the securities markets in Moldova.

To ensure the success of economic and social reforms and the sustainability of economic growth, the infrastructure of the Moldovan securities markets needs to align both to international standards and to the needs of the national economy.

A serious problem for the development of the securities markets in Moldova is the discrepancy between the dynamics of economic growth and the development of national investment sources.

Thus the main task, on the macro-economic level, is to reorient demand from consumption to savings; state policy needs to stimulate the demand for investment. In these conditions, the securities markets will become the priority mechanism of the market economy, attracting investment and redistributing capital throughout the economy.

The market infrastructure

The infrastructure of the Moldovan market corresponds to existing structures in developed markets: the regulated market is represented by the Stock Exchange of Moldova (SEM), the clearing and settlement of stock exchange transactions is performed by the National Depository of Securities (NDS), while 14 independent registrars keep evidence of securities holders. There are also 21 brokers and four share evaluation companies. However, the investment funds and the fiduciary companies established during the privatisation process that has occurred since the end of communism are now due to be liquidated or reorganised into joint-stock companies because they failed to fulfil their main purpose: to attract investments into privatised enterprises.

Major problems

A number of problems have arisen during the evolution of the securities markets which hinder its ability to attract investment.

The most important problems are as follows. There are:

- limited financial instruments characterised by low liquidity, therefore not attractive for potential investors
- no strong investors in the securities market, whether institutional investors or mutual investment funds, and also no efficient investment administration
- high levels of caution from investors and entrepreneurs about investing in Moldova due to the weak judiciary, legal instability, sophisticated tax system, high level of corruption, continuing political uncertainty with regard to the Transnistrian conflict
- internal economic risks, such as high inflation, negative international debt payment balance and trade embargoes.

Moreover the privatisation process has had a negative impact on the evolution of both the primary and the secondary securities market. The most apparent effect of the privatisation of state enterprises was the appearance of a great number of joint-stock companies (JSCs). Many of these are “open” JSCs in name only. In reality they are closed companies; most do not follow the open companies’ approach of attracting supplementary financial funds through the mechanisms of the securities market.

In addition, problems on the financial markets have made small investors wary. Inflation has reduced people’s savings, and the failure of investment funds and fiduciary companies has led to disillusionment about the priorities and efficiency of the market. Consequently, most people now regard the securities markets as an unattractive prospect for investment.
At the same time there has been an intensification of the issuing process and of transactions on the secondary securities markets (see Table 1). This is particularly the case in the banking sector, which has recently attracted huge foreign investment. For example, large foreign banks, such as Société Générale of France, Italy’s Gruppo Veneto Banca, as well as some other well-known foreign investment funds from Austria, Slovenia and the USA, recently purchased controlling stakes in Moldovan commercial banks. This has raised interest in bank securities on the secondary market and their price has more than doubled during a relatively short period of time.

The legal framework of the securities market

There have been recent reforms of the regulatory aspect of the securities market. The three laws below have been amended recently by the Moldovan parliament in order to stimulate the capital market in Moldova:

- Law on the National Securities Commission
- Law on Joint-stock Companies

### Amendments to the law governing the National Securities Commission

To replace the National Securities Commission, a new financial regulator has been created called the National Commission of Financial Market (NCFM). This structure has the authority to regulate, supervise and control all non-banking financial organisations. The competence of this new regulation body, called a “mega-regulator” by some specialists, extends to the securities markets (formerly regulated by the National Securities Commission), the insurance market, savings and lending organisations, microfinance organisations, private pension funds and credit history offices (see Chart 1). The NCFM is a public body, subordinate to parliament and has organisational, functional and financial independence.

The NCFM’s organisational independence stems from the fact that it is not part of the government. Members of the governing committee of the NCFM are nominated by parliament for a two- or three-year period. Decisions of the NCFM are final and there is no government authority above it that can cancel or change its decisions, giving it functional independence. This however does not prevent the affected parties from appealing against NCFM decisions in court, as with any other public authority decision.

The NCFM’s financial independence is ensured by the fact that it is not financed from the state budget, and its own budget is ensured by taxes received from the market operators and taxes on issues of securities and transactions on the secondary market.

The NCFM’s main tasks are to ensure the transparency, security and efficiency of the financial sector by adopting and providing a regulatory framework and adequate supervision of financial market participants.

### Table 1

Transaction volumes on the secondary securities markets in Moldova for January-September 2006-07 (million lei)

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock exchange</td>
<td>284.86</td>
<td>999.70</td>
<td>+714.84</td>
</tr>
<tr>
<td>Over the counter</td>
<td>655.60</td>
<td>528.24</td>
<td>-127.36</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>940.46</strong></td>
<td><strong>1527.94</strong></td>
<td><strong>+587.48</strong></td>
</tr>
</tbody>
</table>

Source: Capital (Special Edition: Market), publication of the National Commission of Financial Market, 4 December 2007, at www.capital.market.md
Amendments to the law governing joint-stock companies

The amendments to the Law on Joint-stock Companies were drafted in accordance with international standards on corporate governance – the OECD Principles of Corporate Governance – following advice and recommendations from the World Bank, the EU,1 and the Foreign Investors Association.

The references to the type of the company – open or closed – have been abolished. All JSCs are now equal in their legal status and all shareholders now have the right to transfer their shares freely.

Special attention has been paid to identifying those JSCs which are required to disclose information about their activity and to provide an annual independent audit of their financial statements. The law provides a list of criteria for determining the companies that are of major interest to the capital market (such as banks, insurance companies, investment funds, private pension funds and some other companies) and the public. These companies will need to ensure the highest level of transparency in their operations.

In line with the OECD principles, the law establishes pre-emption rights, enabling shareholders to acquire newly issued shares in proportion to their shareholdings. This is particularly important for minority shareholders, who will be able to maintain a proportionate ownership of the company.

Other amendments refer to the quorum needed for calling shareholder meetings: in case the first call fails, for the second call the quorum has been reduced from 33 per cent to 25 per cent of voting shares. With reference to adopting decisions on changes to the share capital, the quorum has been reduced from three-quarters to two-thirds of the voting shares present at the meeting. As a consequence the companies often face difficulties in meeting the quorum to appoint the management and the board of directors.

In addition, the law establishes that only the general meeting of shareholders can approve decisions on capital changes. This is in line with international best practice. The previous version of the law allowed the board of directors to take such decisions.

A number of amendments have been made in order to approximate more closely to the OECD principles. The most important of these are the prohibition of cumulating the position of the member of the supervisory council and of the executive body of the company, and modifying the procedure and requirements for approving large and related-party transactions, which emphasise the role of the shareholder meetings.

Amendments to the law governing the securities market

The amendments to the Law on Securities Markets were also caused by the need to harmonise national legislation with the EU acquis communautaire. The main provisions of the new law are detailed below.

Types of securities, their issuing and circulation

The new law provides that only registered securities can be issued and bans the issuing and circulation of bearer securities.

Another amendment refers to the procedure for issuing corporate bonds. A new aspect of the legislation is the possibility of issuing uninsured bonds. The law establishes the conditions for issuing uninsured bonds as well as additional measures of protection for bondholders in case of issuer default.

Chart 1

Financial market authorities in Moldova

<table>
<thead>
<tr>
<th>Until 2007</th>
<th>From 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Banking sector</strong></td>
<td><strong>Banking financial market</strong></td>
</tr>
<tr>
<td>(National Bank of Moldova)</td>
<td>(National Bank of Moldova)</td>
</tr>
<tr>
<td><strong>Securities market</strong></td>
<td><strong>Non-banking financial market</strong></td>
</tr>
<tr>
<td>(National Securities Commission of Moldova)</td>
<td>(National Commission of Financial Market)</td>
</tr>
<tr>
<td><strong>Insurance sector</strong></td>
<td></td>
</tr>
<tr>
<td>(State Inspectorate for Insurance Supervisions)</td>
<td></td>
</tr>
<tr>
<td><strong>Savings and Credit Societies. Microfinance.</strong></td>
<td></td>
</tr>
<tr>
<td>(State Supervision Office of SCS of citizens)</td>
<td></td>
</tr>
<tr>
<td><strong>Other financial market segments</strong></td>
<td></td>
</tr>
<tr>
<td>(Other public authorities/non-regulated areas)</td>
<td></td>
</tr>
</tbody>
</table>

In order to provide an organised secondary market, the law requires that most transactions should be made on the stock exchange. However, there are some cases when the law permits the direct transfer of securities ownership rights via the registrar.

**Professional activity on the securities market**

The classification of professional activities on the securities markets has been modified. These are now divided into “core” and “non-core” activities. This is the first time the law has defined these categories and established requirements for such activities as: the activity of the central depository; market-maker activity; the organisation of trading.

It also establishes additional requirements for the stock exchange and OTC market activity. With the aim of developing the stock market and increasing the number of investors, the status of the stock exchange has been radically changed. The stock exchange will be transformed into a commercial company keeping the functions of a self-regulated organisation. The provision restricting participation in stock exchange capital to brokers and dealers has been abolished, and it is now possible to change the structure of shareholders, with the proviso that no one person can hold more than 25 per cent of the stock exchange’s voting shares.

Taking into consideration the specifics of the national securities market, where only dematerialised nominative securities are traded, the NCFM has created a reserve database of securities holders. This is an important provision because if information is lost from the registries, as result of some force majeure situation, the realisation of rights over the securities becomes impossible. The new provision will act as a back up to boost shareholder protection.

The conditions for the issuing of licences for activity on the securities markets have also been changed, detailing the requirements for the professional participants and their managers.

**Protection of investors on the securities market**

The new law determines those JSCs that must disclose information regarding their securities. Simultaneously, in order to enforce the protection of securities holders, the law introduces the requirement to prepare semi-annual reports.

It also establishes requirements regarding the disclosure of information by trading organisations. With the aim of raising transparency in the regulated market, trading organisations must disclose weekly information about the transactions through audio and visual mass media.

The law also amends the provisions regarding insider trading in line with international best practice. Insiders must not make transactions without disclosing information. An insider can buy or sell securities, both through the public offer of securities on the secondary market and without it, so long as they respect the requirements regarding the market price and information disclosure that can influence the price of securities before making the transaction.

**Conclusions and recommendations**

The amendments to these laws should increase the issuing activity of JSCs and the efficiency of the capital market in Moldova. However, the efficient implementation of these laws, as well as the success of the mega-regulator, will happen only if some conditions are met.

To ensure this, the NCFM should elaborate and adopt a market development programme that would ensure efficient activity and an increase in market participants. This programme should include the following measures:

- ensuring the real independence (organisational, functional and financial) of the mega-regulator
- establishing the unique rules of the financial market
- attracting qualified specialists to the NCFM
- training NCFM personnel
- implementing international best practice with regard to NCFM’s functioning.

In addition, the relationship between the supervisory body and the self-regulated organisations on the financial market should be established, as well as the delegation of some powers and responsibilities to these organisations in the domain of regulation and supervision of the market.

The NCFM should ensure legality and order on the market, the honest behaviour of the professional participants, publicity and transparency. This could be achieved by establishing equal rules of the game for all participants and strict requirements for disclosing information.

The law also amends the provisions regarding insider trading in line with international best practice. Insiders must not make transactions without disclosing information.
The government and the NCFM should fine-tune the capital market with reference to the international principles of corporate governance. This will stimulate the purchase of stocks by individuals. To this end, on 6 June 2007 the NCFM approved the Code of Corporate Governance that establishes mechanisms to protect shareholders rights, and regulates the whole spectrum of relations between government bodies.

At present, only shares are traded on the Moldovan securities market. The issuance of other securities is difficult to realise from a technical and juridical point of view, or is not regulated. One of the NCFM’s main objectives should be to diversify the number of financial instruments and to improve the quality of investment services.

As the capital market increases its contribution to the economy, the stimulation of initial public offerings will boost the attractiveness of JSCs to investors.

The NCFM should try to develop the secondary securities market. Since the Stock exchange of Moldova (SEM) regulates supply and demand, establishes the market price of securities and ensures a high level of transparency, one of the priorities of securities markets regulation must be to support and stimulate stock exchange transactions. In turn, the SEM must elaborate and implement measures that will boost the positive image of the stock exchange and increase the number of market participants.

The NCFM should join the International Organization of Securities Commissions (IOSCO), which will also contribute to implementing international standards of securities markets regulation and supervision.

The realisation of all these measures will have a positive impact on the development of the securities markets in Moldova and will stimulate investment.

Notes

1 “Support to PCA and WTO Implementation and to EU/Moldova European Neighbourhood Policy Action Plan”. The project assists the implementation of the provisions of the Partnership and Cooperation Agreement, of the World Trade Organization and the European Union – Republic of Moldova Action Plan within the scope of the European Neighbourhood Policy. Also it includes consultancy assistance which aims to strengthen the capacity of local structures involved in the process of legal harmonization as well as in the Republic of Moldova – European Union Action Plan implementation. For more information see http://www.delmda.cec.eu.int/eu_and_moldova/pdf/support_to_pca_nap_2003-0307_en.pdf

2 The expression “over-the-counter” refers to stocks that trade via a dealer network as opposed to on a centralized exchange. It also refers to debt securities and other financial instruments such as derivatives, which are traded through a dealer network.

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After a difficult period following the collapse of the Soviet Union, Ukraine is making progress in its economic and political transition. It is now seen as an important partner by its neighbours in the east and the west, with a dynamic economy, a quickly growing domestic market and a lively democratic society. Ukraine has made its ‘European choice’ while at the same time recognising the importance of good relations and extensive commerce with Russia. Overall, for Ukraine, like for other Eastern European countries, the recent years were good in many respects. The quality of life has improved for the majority of the population, business activity in general and foreign direct investments have been constantly on the rise. However, problems remain in many areas, and, notably, the lack of economic and legal reforms together with certain political instability continue to hinder the country’s further growth.

In 2008 Ukraine is hosting EBRD Annual Meeting of Governors. Being the largest institutional investor in Ukraine, for more than a decade the EBRD has been playing an active role in boosting the country’s transition to the market economy. The number of EBRD’s operations has increased dramatically over the past few years as Ukraine has become the Bank’s 2nd largest investment region after Russia. This strong growing tendency is expected to continue.

This section offers a variety of views and topics authored by practising lawyers, bankers, economists, and academics.

In the first article, Valeriy Tsekhanovych and Anna Yegupova of the EBRD provide the current state of affairs in key areas of Ukrainian commercial legislation relevant to investment.
Alan Rousso, Kamen Zahariev, Elisabetta Falcetti and Yevgeniya Korniyenko, all of the EBRD, look into recent achievements, challenges and trends in the private sector of the Ukrainian economy and describe the EBRD response to these challenges.

James Wilson of the EBRD looks into financing the construction of properties leased to developers by Ukrainian municipalities, an increasingly visible and attractive business activity.

Irina Voytyuk, Rector of the Academy of Judges of Ukraine, shares her experience in establishing a national system of education for Ukrainian judges.

Motria Onyschuk-Morozov, Senior Operations Manager, IFC and Vladislava Rybota, Legal Adviser, IFC, focus on the promotion of good corporate governance to private sector companies.

Finally, Oleksander Martinenko, Partner, CMS Cameron McKenna LLC, and Yevhen Deyneko, Lawyer, CMS Cameron McKenna LLC, review the long-awaited draft joint stock company law which has been under discussion in the Ukrainian parliament for almost a year.
Recent changes in the commercial laws of Ukraine
Experience in the EBRD’s countries of operations suggests that advancement of the rule of law and economic transition go hand in hand. The future success of transition in Ukraine will depend in part on improving the quality of the country’s legal system, just as the lack of reform might be the main impediment to its long-term growth. According to the latest EBRD Strategy for Ukraine, the absence of certain much-needed securities regulations, of a new joint-stock company law and of reforms in the insolvency and judicial sectors constrain the development of capital markets and encourage persistent corporate raids.

Characteristics of Ukrainian commercial legislation

Ukraine provides a good example of how geopolitics influences the development of a newly independent country. Since the collapse of the USSR and the recent enlargement of the European Union (EU), Ukraine has found itself situated between two major world powers – Russia and the EU. Understandably, Ukraine may be tempted to compare, adapt and apply the experience and legislative models of its neighbours. However, finding its own political identity and developing a balanced foreign policy have proved to be a complex and delicate exercise.

On one hand, Ukraine continues to have historically strong political, cultural, and economic ties with Russia. Commercial implications are especially important: the Ukrainian and Russian economies remain closely linked. On the other hand, Ukraine feels cautious about becoming more dependent on an increasingly powerful Russia and would like to develop its relationship with the EU further. Over recent years, we have witnessed that this choice is difficult both for Ukrainian politicians and for the Ukrainian people, who remain largely divided on which course the country should take. One thing is clear, however: Ukraine’s legal environment will inevitably reflect any change in the political course chosen by the country.

Ukrainian commercial legislation, like that of Russia and other CIS countries, has its origins in the Soviet legal system. After 1991, Russian and Ukrainian laws developed in parallel and have many common features. At the same time, the European influence on the Ukrainian legal framework has become increasingly important. The EU and Ukraine have a well-established track-record of close economic and political relations. The existing contractual framework is based on the Partnership and Cooperation Agreement (PCA) which was concluded in 1994 and entered into force in March 1998. Article 51 of the PCA recognises the importance of approximating legislation to strengthen economic links between Ukraine and the EU and identifies a number of priority areas, including company law, accounting and taxes, banking, financial services, competition law and so on.

Since 2002, Ukraine has made significant efforts, with EU assistance, to define goals and tasks in pursuit of its legislative approximation programme. The EU-Ukraine Action Plan dated 21 February 2005, which sets out a comprehensive set of priorities within and beyond the scope of the PCA, states that one of the priorities for action is the “gradual approximation of Ukrainian legislation, norms and standards with those of the European Union”. It is, therefore, important to take a dynamic approach in assessing current Ukrainian commercial law and to understand it as being oriented towards European Union norms and standards.
Looking into the future, Ukraine will try to adapt the best European legislative experience to its own reality, but how successful have these efforts been so far? What has been achieved in real terms? The EBRD, carrying out regular assessments of legislation in its countries of operations, notes that Ukraine’s compliance with best international standards in major areas of commercial law ranges from “very low” in insolvency law to “high” in capital markets. Although this may be a matter of timing (it is impossible to change all areas of law simultaneously), it has to be pointed out that in many instances numerous attempts have been made to amend and improve bad or inefficient laws rather than replacing them completely with modern acts. A comparative assessment of current Ukrainian legislation leads us to stress its strikingly uneven quality.

Another important characteristic applicable, unfortunately, to various sectors of Ukrainian law, and to commercial law in particular, is the lack of a common system and consistency. Ukrainian commercial legislation does not seem to be working harmoniously as an integral mechanism. This is not surprising, taking into account that in some cases (the obvious example is that of the Civil and Commercial Codes of Ukraine dated 16 January 2003), closely related laws were developed by groups of specialists completely independently and without proper coordination. In addition, when a new law is enacted, rarely are comprehensive changes made in parallel to all related laws and other legislative and administrative acts to ensure that the new law works smoothly and without contradiction in the context of the entire legal system. Application of conflicting laws covering the same subject often creates confusion, results in court disputes and becomes a breeding ground for corruption.

Finally, commercial activity in Ukraine remains extremely overregulated. The system still enables state authorities to interfere unnecessarily in all spheres of business. Although thousands of regulatory acts were abolished in 2005, the results were minimal because those cancelled were archaic documents which had little to do with business regulation and which were rarely applied in practice. These are the general features which, in our opinion, define current Ukrainian commercial legislation as a complex and dynamic system. We will now evaluate key areas of commercial law which are of particular interest to foreign investors.

Capital markets

The EBRD Securities Markets Legislation Assessment carried out in 2007 showed Ukrainian legislation to be in “high” compliance with the standards recommended by the International Organization of Securities Commissions (IOSCO) (see Chart 1). During the course of the assessment, Ukrainian capital markets laws were measured against the 30 principles of securities regulation which are designed to ensure the protection of investors, fair, efficient and transparent markets, and the reduction of systemic risk. Some of the areas where Ukrainian laws still fall short of the IOSCO standards include the absence of:

- regulations on listing particulars
- ongoing obligations to report shareholding changes
- provisions on mandatory tender offer in the event of change of control of a publicly-traded company
- legal and regulatory safeguards for assets held by funds
- public disclosure of information on licensed financial intermediaries
- policies and procedures designed to prevent the use of intermediaries as vehicles for money laundering
- specific regulations on the trading of certain derivatives.

The high level of compliance with the IOSCO standards was achieved in part due to a number of laws which the Ukrainian parliament adopted in the last two years. In particular, the new Law on Securities and Stock Market dated 23 February 2006 replaced the law passed in 1991 and introduced new regulations on listing and prospectus requirements, insider information and trading and the activities of stock exchanges.
This law also removed the requirement to denominate corporate bonds in Hryvnia only. However, an equivalent Hryvnia requirement remains in the Commercial Code dated 16 January 2003, leaving it unclear whether a direct foreign-currency issuance is permitted. Due to this and other regulatory restrictions, Ukrainian deal structures have to be constantly refined in order to reduce costs and ease execution. Since the first placement by local telecom operator Kyivstar in 2002, issuers of Ukrainian corporate and municipal eurobonds have utilised the loan participation notes (LPN) structure, which involves an arms-length intermediary or a special purpose vehicle (SPV) providing a back-to-back loan or two intermediaries acting as a lender and an issuer on a subparticipation (assignment) basis.\(^7\)


Securitisation provides an attractive reduced-cost financing alternative via segregation of assets from the credit risk of the originator and higher credit rating of the securities issued by the SPV. A further rating uplift may be achieved when an international financial institution such as the EBRD participates in the transaction as either an investor or a purchaser of assets from the originator.\(^8\) Since Ukrainian law does not allow domestic companies to issue securities abroad, cross-border securitisation in Ukraine typically involves a foreign SPV acting as an issuer of securities in international capital markets. The first PrivatBank securitisation was structured as a true sale of PrivatBank’s rights of claim under a mortgage loan portfolio to a UK company, which issued mortgage-backed notes to fund the purchase of the rights of claim.\(^9\)

Despite these legislative developments, securitisation in general is still subject to relatively complicated Ukrainian banking, currency control and secured transactions laws. Securitisation of non-mortgage products remains unregulated.

Secured transactions

Over the last few years, Ukraine has undertaken considerable reforms in the area of secured transactions. The introduction of specific laws on taking security and extensive work on supporting institutions, such as the creation of security registers, have greatly facilitated lending transactions, in particular mortgage finance. The electronic centralised registers maintained by the Information Centre of the Ministry of Justice comprise the State Register of Mortgages, the Unified Register of Prohibitions on Alienation of Immovable Property Objects, the State Register of Ownership Rights to Immovables and the State Register of Encumbrances over Movable Property. Collectively, they enable efficient registration of security rights over all types of movable and immovable property and nationwide searches for existing liens.

On 16 November 2006, the parliament passed amendments to the Law on Banks and Banking allowing foreign banks to open branches in Ukraine provided, among other things, that the banks’ countries of origin cooperate with the Financial Action Task Force (FATF) and comply with the Core Principles for Effective Banking Supervision of the Basel Committee on Banking Supervision.\(^10\) This measure, which is expected to stimulate competition and increase efficiency in the banking sector, will enter into force as of the date of Ukraine’s accession to the World Trade Organization.\(^11\)

Security rights over immovable property are regulated by the Law on Mortgage dated 5 June 2003, which streamlined the creation and perfection of mortgages, protected the priority of earlier registered creditors and expanded the scope of available enforcement options. The mortgage can extend to land, buildings, unfinished construction and certain lease rights. In accordance with the Land Code dated 25 October 2001, agricultural land may only be mortgaged to banks.

The mortgage becomes effective (and can be enforced against the mortgagee upon default) from the moment of notarisation of the mortgage agreement. To ensure priority over subsequent creditors, the mortgage must be entered into the State Register of Mortgages.
A subsequent mortgage over the same collateral would only be permitted if the existing agreement does not prohibit it and the existing mortgagee consents. Paradoxically, an existing unregistered mortgage may effectively prohibit the creation of a later one, even though the subsequent creditor has no practicable means of searching for existing liens outside of the State Register of Mortgages (a prospective creditor would have to search the records of all local notaries who might have registered a mortgage over a particular land plot or building). In practice, creditors rely on the borrowers’ representation as to the absence of pre-existing liens (in any event, the Law on Mortgage obliges the mortgagor to inform the mortgagee of any such pre-existing liens).

In addition to enforcement through court or a notarial writ of execution, the mortgagee may acquire the collateral directly or sell it to a third party. In the event of the debtor’s bankruptcy, the collateral will be included in the bankrupt’s estate and sold with the rest of its assets; however, the law gives priority to secured claims up to the value of the collateral. 12 transactions regime lie in taking and enforcing security over fungible goods, floating assets, bank accounts, enterprises (so-called entire property complexes), and implementation of the new methods of extra-judicial enforcement described above.

**Insolvency law**

In 1992, less than a year after the Soviet Union collapsed and Ukraine declared its independence, a package of new commercial laws was adopted. The Law on Bankruptcy was one of them and was aimed at facilitating the privatisation of numerous inefficiently run state enterprises which were an enormous burden to subsidise. It quickly became apparent, however, that this law was of little use in reforming the Ukrainian economy. Very few bankruptcy cases were initiated and in those that were, the law was often used by the management of potentially solvent companies for their own lucrative purposes. During the first years of the new Ukraine, many business directors obtained control over the state-owned enterprises that they themselves still managed by devaluing their assets and bringing them to bankruptcy on purpose. By using the law for the wrong purposes they avoided time-consuming privatisation procedures and any need to offer the stock to the general public. 14

In 1995 extensive work began to amend the law but it was not until 2000 that the new insolvency legislation came into force. The first draft of the new law, which was adopted in 1999 and named the Law on Restoration of Solvency of the Debtor or Declaring the Debtor Bankrupt, was prepared by a group of reputable academics and experienced judges (including a foreign expert, a bankruptcy judge from the Central District of California) with a significant input from the Ministry of Justice, the Ministry of Economy and other state bodies. To a certain extent it followed the approach of the Model Law on Insolvency (Bankruptcy) developed by the Scientific Consultative Centre of Private Law of Commonwealth of the Independent States as exemplary legislation for adoption in CIS countries.

Analysis of the 1999 law shows that although it was a significant step forward compared with the previous law, it is still severely deficient in most fundamental areas of insolvency. This law scored “very low compliance” when compared with international standards in the EBRD’s 2004 sector assessment survey.

On the positive side, however, commentators note that the law has introduced a number of modern principles that were previously unknown in the Ukrainian insolvency system. 15 For example, the insolvency law declares the need to protect not only creditors’ interests but also those of debtors. Bankruptcy proceedings can now be initiated against individuals registered as entrepreneurs, non-commercial organisations including charitable and other funds and so on. Importantly, so-called “state enterprises with special status” are excluded from this list. The law also introduces a new concept of “interested persons”, provides for a range of insolvency procedures (including out-of-court amicable agreements) and, for the first time in the legislative history of Ukraine, a special state body on bankruptcy matters has been created: the State Agency on Bankruptcy Affairs.

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*The insolvency law declares the need to protect not only creditors’ interests but also those of debtors.*
Overall, the Civil Code and the Commercial Code did little to add more order and clarity to the existing legal framework on corporate governance.

At the same time, it should be highlighted that serious concerns arise with respect to such a key area as the restructuring process. Although the law is notable for allowing the conversion of a bankruptcy to a restructuring and vice versa, the restructuring process is inadequately documented. The general body of creditors is not sufficiently involved in preparation of the plan of reorganisation. There is no requirement for the independent assessment of such a plan and no supervision of its implementation is envisaged. The law fails to provide for the timely delivery of the debtor’s property to the bankruptcy administrator or for the effective avoidance of suspicious pre-bankruptcy transactions. Given these limitations, it seems unlikely that an effective, efficient and transparent reorganisation could take place under this law.

In addition to these fundamental failings, the law has a number of other serious shortcomings. In particular, the requirements for commencement of bankruptcy proceedings are too complicated; there are inadequate requirements for the qualification of a bankruptcy administrator; there are no provisions for set-off; and there are insufficient sanctions for failure to comply with the law. Chart 2 presents the results of the EBRD Insolvency Sector Assessment 2004.

The results of the EBRD 2004 Legal Indicator Survey, which measured “effectiveness” (how the laws work in practice) of insolvency regimes in the Bank’s countries of operations, clearly show that the practical application of the 1999 insolvency law is likely to be expensive, fairly slow and unduly complex (see Chart 3).

Corporate governance

Corporate governance remains a problematic area of Ukrainian commercial legislation. The first laws addressing corporate governance issues were the Law on Enterprises in Ukraine dated 27 March 1991 and the Law on Business Associations of 19 September 1991. Although these laws established general and basic principles, it quickly became apparent that they were not sufficiently comprehensive to address the need to regulate a rapidly increasing number of Ukrainian companies. This was especially relevant to large privatised state companies with a diverse shareholder base, that appeared in the immediate post-Soviet era.

Numerous presidential decrees and mandatory rulings of the SSMSC, which filled gaps in legislation, continued to be an important source of corporate governance regulations. In addition, in 2003 the Ukrainian Corporate Governance Code was enacted. The code’s principles are intended for open joint-stock companies traded on the stock market and are voluntary. Few companies have adopted these principles but the number may rise in the future together with the number of the companies listed on Ukrainian stock exchanges.
In 2004, the Civil Code and the Commercial Code introduced a few important rules targeting, in particular, conflict of interest transactions and controlling shareholders’ duties and liabilities. Overall, however, these codes – which were developed without proper coordination – did little to add more order and clarity to the existing legal framework. Numerous provisions conflict with each other and a complicated interpretation exercise is needed in order to understand which provision prevails in a specific scenario. When most recently assessed by the EBRD, in 2004, Ukrainian corporate governance legislation was measured as being in “very low compliance” with the principles developed by the Organisation for Economic Cooperation and Development (OECD). In particular, disclosure rules concerning company information were found to be inadequate, the duties of a company’s board of directors unclear and the provisions concerning shareholders rights insufficient (see Chart 4).

In 2005, the EBRD conducted a survey to test the effectiveness of corporate governance (how the law works in practice) through a case study dealing with related-party transactions. The case study investigated: (i) the position of a minority shareholder seeking to access corporate information on a presumed related-party transaction; and (ii) how compensation could be obtained in case damage was suffered. Effectiveness of the system for both questions was assessed based on four principal variables: complexity, speed, enforceability and institutional environment. The survey revealed that a minority shareholder – owning more than 10 per cent shareholding – has, by virtue of law, access to different avenues to seek disclosure from the company (for example, shareholders can request an independent audit or call a shareholders meeting to ask for information from the management). Unfortunately, all actions are quite complex and lengthy as it is quite easy for the company to delay the proceedings. The difficult enforcement and the weak institutional environment add to the complexity of the actions.

As discussed above, the new Law on Securities and Stock Market significantly improved the situation with regulation issues applicable to companies trading their securities on the Ukrainian stock market. At the same time, a long-awaited draft of a new Law on Joint-stock Companies has been under consideration by the Verkhovna Rada (or Ukrainian parliament) since February 2007, when it was approved by the Cabinet of Ministers. Once this is adopted by the Rada and signed into law by the President, it is expected to improve the legal framework further.
Recent changes in the commercial laws of Ukraine

Notes


3. See note 2.


6. The main stock exchanges in Ukraine are the First Fund Trading System (PFTS), with 296 listed companies (as of 31 December 2006) and market capitalisation of approximately US$ 107 billion (as of 19 December 2007) (http://www.pfts.com), and the Ukrainian Stock Exchange, with 54 listed companies (as of 19 December 2007, http://www.ukrse.kiev.ua).


8. Nick Eisinger, Greg Kabance. Legal Uncertainty in Emerging Market Transactions: ABS/Emerging Markets Criteria Report: February 2007, Fitch Ratings, p. 3. Although the EBRD has participated in a number of securitisation deals in Russia, it is yet to undertake such a deal in Ukraine.


11. As of the time of writing, Ukraine’s accession was expected to be approved at the WTO General Council meeting on 5 February 2008.


15. A. Biryukov. Ukraine’s Recent Bankruptcy Reform. (http://www.ageyev.org/articles/biryukov/UkrainianBankruptcyReform.pdf)
Part II • Legal reform in Ukraine

Private sector development and the EBRD in Ukraine
The private sector in Ukraine is gradually gaining in importance after more than a decade of reform. This article discusses the obstacles to private sector investment, both national and international, and outlines the EBRD’s efforts to help improve the situation.

Ukraine’s transition to a market economy and multi-party democracy has been episodic. Intense periods of economic reform and political openness have been punctuated by longer stretches of policy inaction and, occasionally, retreat.

Unlike some of its neighbours to the west, and Russia to the east, Ukraine did not go through a period of shock therapy and rapid privatisation, liberalisation and democratisation. Instead, Ukraine pursued a more gradual path of reform. In a similar way to other transition economies on the same trajectory, partial reform in Ukraine was locked in place by newly empowered business and political elites who benefited disproportionately from the resulting distortions in the legal and regulatory framework, in capital, product and labour markets and in political institutions.

The development of the private sector, although growing as a share of total output, was impeded by a heavy state presence in the economy and the use of administrative controls, high levels of corruption and an uneven application of the law that favoured some business groups over others. While economic growth picked up in the years following the 1998 financial crisis in Russia, Ukraine’s estimated total output today is less than 70 per cent of what it was in 1989, suggesting that the slow introduction of reforms has exacted a price.

The Orange Revolution in 2004 was a turning point in the economic and political transformation of Ukraine. Although policy articulation and implementation since 2004 has been inconsistent, the overall direction the country has taken – asserting its national sovereignty and moving towards a pro-European development strategy – has brought tangible signs of progress.

Over the last three years, there has been a strong increase in foreign direct investment (FDI) in Ukraine, with several foreign banks entering the market. Growth has rebounded from the economic decline that followed immediately after the Orange Revolution, thanks to a boom in private consumption, fuelled by credit growth, increases in wages and pensions and strong investment activity. Industries have showed a high degree of resilience to higher energy prices, absorbing a more than twofold increase in the price of gas imported from Russia since 2005.

However, Ukraine still faces major transition challenges. Reforms are far from complete and more needs to be done to stimulate private sector development, to increase the competitiveness of Ukrainian business and to make growth sustainable. Below we review progress in private sector development and the business environment in Ukraine since the start of its transition towards a market economy, highlighting some of the main challenges ahead and summarising EBRD activities in Ukraine to date.
Private sector development

The size of the private sector

In Ukraine, the private sector share of GDP grew rapidly in the first decade of transition but has remained relatively stable since 2000 (see Chart 1).\(^1\)

Chart 1 shows an upward trend in the Ukrainian private sector’s share of GDP, from 28 per cent on average during 1991-96 to around 58 per cent in 1997-2001, with modest increases during 2002-06 to reach 65 per cent. Although on average the size of the private sector in Ukraine is higher than in the Commonwealth of Independent States and Mongolia (CIS+M) region and is catching up with south-eastern Europe, it remains well below the central European and Baltic (CEB) states, where private sector activity accounts on average for about 75 per cent of GDP. In Ukraine the state still retains a large share in the economy (35 per cent of GDP), due to the still-unfinished privatisation agenda.

Progress in privatisation

The privatisation of state assets has contributed to the rise in private sector activity. While the small-scale privatisation process is nearly complete in Ukraine, the sale of large strategic enterprises and public utilities has lagged behind (see Chart 2). Relative to other countries in the CIS+M, large-scale privatisation was slower than average in the early years of transition, but has since accelerated.
Privatisation revenues are an important source of budgetary financing. Net privatisation receipts peaked at US$ 4.1 billion in 2005, mainly due to the resale of Kryvorizhstal, Ukraine’s largest steel mill, to Mittal Steel for 24.2 billion Hryvnia (US$ 4.8 billion) in October 2005. However, no other major privatisation has taken place since then and the government privatisation targets have been repeatedly undershot.

Investors’ lack of confidence in Ukraine persisted for another three years, despite improving macroeconomic fundamentals. The situation improved in 2002 after Ukraine completed the restructuring of its debt to the Paris Club of creditors. Since then, there has been a significant upturn in private investment flows to Ukraine, with the annual average for 2003-07 amounting to US$ 5.3 billion (see Chart 3).

Compared with CEB and south-eastern Europe (SEE) averages, Ukraine has been less successful in attracting FDI, reflecting a slower pace of reform, the late start of the privatisation process and a more difficult business environment (see below). In per capita terms, cumulative net FDI inflows to Ukraine totalled only US$ 455 in 1989-2006, compared with US$ 2,142 to Poland and US$ 4,545 to Hungary.

The privatisation of large state-owned enterprises (energy, metal and metal products) and the entry of foreign strategic investors in the banking sector have been important sources of FDI inflows to Ukraine. The foreign-owned share of total banking assets has increased from 10 per cent in 2000 to above 40 per cent by the end of 2007.

Further privatisations in a number of key economic sectors, including energy, public utilities, mining, transport and telecommunications which have been put on hold in the past few years could yield significant FDI inflows in the future. If structural reforms resume and macroeconomic stability can be maintained, FDI inflows into Ukraine could quickly reach the levels observed in countries with a similar size and economic structure, such as Poland.

Key challenges for private sector development

Strengthening the business environment

Ukraine’s business environment has shown signs of improvement in recent years, especially as the country has moved more confidently in a democratic pro-European direction. The checks and balances and greater transparency that have accompanied Ukraine’s democratic progress have been reassuring to foreign investors who have responded favourably to these developments. However, lingering uncertainties regarding political leadership and frequent changes in government since the Orange Revolution...
in 2004 have delayed the implementation of many of the most urgently needed improvements in the business environment.

Two such necessary improvements that have received high-level attention in recent years are rule-of-law reform and the fight against corruption. Although legal reforms have made some progress, with Ukraine’s legislature adopting several key market-supporting laws in accordance with its World Trade Organisation (WTO) and European integration agenda, implementation remains a weak point.

In particular, significant problems remain with regard to judicial integrity and independence, consistency among laws and the politicisation of rulings and enforcement. As seen in Chart 4, courts in Ukraine were judged to be considerably less fair and honest than courts in both advanced transition countries and mature market economies, according to the latest round of the EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS).

These problems have impaired the ability of both domestic and foreign firms to do business in Ukraine in myriad ways. First, weak courts that are not seen to uphold the law even-handedly cannot be relied upon to resolve business disputes fairly, thus limiting a firm’s choices of business partners to only those with whom it already has longstanding ties or family/kinship relations. Secondly, Ukrainian firms trade less on credit and more on prepaid sales than do firms in advanced transition countries, in part due to their lack of confidence in third-party enforcement of contracts. This ties up firms’ working capital and inhibits flexible financial management. Another serious problem that stems from the weak rule of law in the country is the high incidence of corporate “raidering” whereby firms are taken over by either minority or majority shareholders with the implicit or explicit cooperation of corrupt judges. This practice has weakened the property rights regime in Ukraine.

Corruption has also received increasing attention, as both high level and administrative corruption in the public and private sectors in Ukraine is perceived to be a significant policy challenge. The close association between business and politics, still a strong feature of the political system even after the Orange Revolution, contributes to the problem of high-level corruption or “state capture”. High level corruption, and the privileges it bestows on well-connected firms, undermines competition and limits the space for private sector development. Ukrainian authorities freely admit to the severity of this problem and have pledged to
tackle it through a series of policy initiatives, including laws on conflict of interest and asset declaration for public officials, removing immunity of elected representatives to the legislature and other measures.

Administrative corruption is still a significant problem for business, according to the last round of the BEEPS. Although the problem has become less severe in recent years, more than 60 per cent of respondents in Ukraine still see corruption as an obstacle to doing business. Firms in Ukraine pay more in “unofficial payments” as a share of annual sales than in other parts of the transition region, including both the advanced transition countries and the CIS (see Chart 5).

Small firms and private firms appear to bear the heaviest burden when it comes to making these unofficial payments (see Chart 6), which occur most frequently when obtaining business licenses and permits, dealing with fire and building inspectors, tax administration and dealing with courts. Other surveys confirm these findings. Administrative and regulatory reforms, which would simplify the rules and reduce the influence of public officials who oversee business areas, have been slow in coming and those that have been adopted have not been consistently implemented. Regulatory policy uncertainty, tax administration, frequent tax inspections and difficulties obtaining business licences and permits top the list of regulatory obstacles that firms face (see Chart 7). Access to land is also a key complaint among businesses in several surveys. On average, senior managers in Ukraine spend far more time dealing with officials to interpret laws and regulations than in the CIS or CEB.

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Access to finance and development of SMEs

As the banking sector has developed over the past few years and foreign banks have entered the Ukrainian market, firms increasingly have better access to finance for their working capital and investment needs. Over the past 10 years, credit to the private sector as a share of GDP has grown by 78 per cent, which has helped fuel domestic consumption and investment and, in turn, robust economic growth. More firms now use bank loans rather than loans from family and friends or retained earnings to finance investment than in the past, as the terms (interest rates and maturity) have improved and the time required to negotiate a loan is below the average for mature market economies (see Charts 8 and 9). However, access to finance for SMEs and for private firms remains a large obstacle to operating a business.

SME development in Ukraine has been encouraging, despite the obstacles such companies face in the business environment and in accessing finance. SMEs have tended to perform better than larger enterprises, contributing disproportionately to growth in recent years. They have been adding more jobs to the economy and at the same time have been gaining in productivity (in terms of output per employee). The largest number of SMEs is in wholesale and retail trade, which accounts for just under 70 per cent of the total number of SMEs in the country and employs around 26 per cent of the total number employed in the SME sector.

Market access, trade and competitiveness

Ukraine’s structure of industrial production and exports is highly concentrated and consists predominantly of goods with a low
degree of processing and value added. This structure has been inherited from the former Soviet Union and little has been done in the past fifteen years to restructure it.

The three largest categories of Ukrainian exports – metals and metal products, chemical products and agricultural products – accounted for approximately 66 per cent of total exports in 2006 (See Chart 10 a). This structure has remained almost static since the beginning of Ukraine’s transition to a market economy.

This can be partly explained by the artificially low gas prices before 2006 – which favoured further specialisation in energy-intensive goods and delayed the process of modernisation in the steel and chemical industries – and a positive external environment with high prices and demand for those goods. The country still has a strong comparative advantage in agriculture and food processing, and this sector was the third largest export item after metals and machinery in 2007. However, Ukraine’s accession to the WTO, expected in 2008, is likely to intensify pressures on agricultural and machinery building industries to reform. Eventually this will increase efficiency by forcing the restructuring of existing unproductive capacities but such measures could have a short-term transitory negative effect on trade capacity.

The geographical structure of Ukrainian exports has remained relatively stable in recent years. After a period of substantial reorientation away from CIS markets in the early 1990s, since 2000 the CIS markets and Europe account for around a third of Ukrainian exports (see Chart 10 b). Due to the growing demand from China and other Asian countries for steel and metal products, Asia’s share in the geographical structure of Ukrainian exports increased to 21 per cent in 2006.

On imports, Ukraine has done a great deal since the 1990s to reorient its imports from CIS countries to Europe. The introduction of energy-saving technologies and alternative sources of energy will help to further reduce imports of energy from Russia and other CIS countries. However, it will require higher and more sustained FDI inflows to help Ukraine deepen its trade integration into the global economy.

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In order to help address the challenges above, the EBRD has established a series of strategic priorities for Ukraine:2

- assisting foreign direct investment and promoting increased efficiency, competitiveness and corporate governance standards in the local private sector.

During the last three years Ukraine has risen to become the EBRD’s third largest investment region (after Russia and Poland), representing approximately 8.7 per cent of the Bank’s signed commitments at 31 December 2007. By the end of 2007 the Bank had invested in 161 projects with a net cumulative business volume of €3,241 million. Of this, private sector projects represented 73 per cent of the total volume. Over the period of the last country strategy, the new annual commitments of the Bank reflected this growth. Throughout this period (2005-06) annual commitments in Ukraine were the second largest in the Bank’s countries of operations after Russia, reaching €798 million in 2006.

The Bank actively participates in financing key foreign investors in Ukraine, such as Arcelor Mittal and IKEA. It also finances cross-border transactions with sponsors from other transition countries such as the Polish sanitaryware producer Cersanit, floorboard producer Barlinek and Serbian Agroinvest. In addition, the EBRD has significantly intensified its investments in the Ukrainian property sector with loans to IKEA, property developer Cantik and by participating in two commercial property funds.

The level of commercial co-financing significantly increased to 100 per cent of Bank financing in 2007 compared with 22-40 per cent in 2004.

The significant increase in co-financing reflects the rising importance of Ukraine’s corporates in the syndication markets.

A milestone was the first co-financing in Ukraine with the Japan Bank for International Cooperation (JBIC) for US$ 120 million in the context of the Ekoenergiya cogeneration project for the Alchevsk Steel Mill.

- promoting the development of the domestic capital markets and providing continued support to private MSMEs through dedicated long-term credit lines with partner banks

The EBRD successfully pursued its strategic goal of developing local currency financing instruments in 2007 with the launch of KievPrime, the interbank money market index which will become the basis for EBRD financing in Hryvnia.

In the financial institutions sector, the Bank completed successful syndications in favour of local commercial banks, such as Kreditprom bank. Provision of mortgage finance for Forum bank and finance for small and medium businesses continued through EBRD credit lines to Mega bank.

The Ukraine Micro Lending Programme expanded considerably with seven local partner banks actively lending to micro and small enterprises (MSEs) through 719 branches in over 250 cities in 25 regions of Ukraine. At the end of 2007, the programme had disbursed US$ 2.4 billion in over 370,000 micro and small loans.

- promoting energy efficiency and security, environmental protection and sustainable use of natural resources throughout all sectors of the economy

The EBRD pursued its strategic goal of supporting environmental protection and energy efficiency related projects in 2007 with a €100 million industrial energy efficiency credit line from three local banks and with the financing of a large co-generation facility for Alchevsk Steel mill. This project will generate significant environmental benefits and energy savings and is the first project with a large locally owned industrial group, the Industrial Union of Donbas, which is applying higher standards of corporate governance and transparency.

What is the EBRD doing to help?

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1 Estimating the size of the private sector in transition economies is not an easy task because data coverage is often incomplete and many firms operate in the informal economy in order to evade taxes, registration requirements and other costs of doing business. According to various estimates, the informal economy may account for nearly half of the country’s economic activity.

Legal issues involved in financing the development of commercial real estate in Ukraine
The EBRD has recently been considering a number of loans to finance the construction of properties on land leased by clients from Ukrainian municipalities. One important objective for the EBRD in all such projects is to facilitate land privatisation by helping clients to purchase the state’s interest in the land concerned. This article outlines some of the primary legal and structural issues involved in financing projects of this type.

In Ukraine, much undeveloped land is still owned by the state and operated by local municipalities who grant land lease rights to private Ukrainian entities so the land can be developed for the benefit of the local community. Since the adoption of the new Land Code of Ukraine it has been possible for Ukrainian entities to use such a land lease for development as a first step to the full privatisation of the land and buildings constructed on it.1

Importance of this type of financing to Ukraine

On 31 October 2007, the Ukrainian government announced its programme for the development of municipal land in preparation for Ukraine’s hosting of the European Football Championship in 2012. With authorised government expenditure of approximately 125 million Hryvnia and development projects including urban regeneration and major social infrastructure projects, as well as the construction of sports stadia and other related public facilities, it is clear that the development and privatisation of municipal land is set to assume increasing importance for Ukraine in the years ahead.

Financing these projects is also an important way in which the EBRD can contribute to the development of Ukraine’s commercial real estate in the municipalities. This is particularly the case in the area of infrastructure projects and the development of commercial retail centres: the EBRD can support a project that brings much-needed benefits to the local community and can also facilitate land privatisation. The EBRD’s involvement encourages the public sector in Ukraine to take an active role in the process and ensures that such privatisations are conducted in a proper manner.

How land leases are granted by municipalities

In many cases, the municipality offers these development rights in a tender process under which Ukrainian entities are invited to make financial proposals for the development of the land in question.2 The resulting land lease rights are therefore designed to allow the developer to construct on and develop the land fully according to its proposed project timetable. In order to encourage developers to act quickly and stick to their timetable there will usually be a relatively short initial lease term.3

The land will be zoned (or will be subject to re-zoning) according to the type of development proposed and usually local municipal legislation will describe more precisely how the land should be developed according to the developer’s timetable for phased construction.4

Under Ukrainian law, the developer automatically acquires a full interest in any constructions it builds on land leased from the municipality (the lease does not extend to buildings constructed on the land so that the interest in such constructions vests with the developer and not with the Ukrainian state or municipality). Once the construction has been completed and the relevant public authorities have issued a commissioning certificate the developer can then apply to purchase the municipality’s interest in the land by way of land privatisation. This means that the tenant becomes the full legal owner of the land and the buildings constructed on it.
Challenging financial structures

The EBRD is currently considering the financing of a number of real estate developments where the borrower (or affiliated companies within the sponsor’s group) holds only land lease rights from the municipality at the outset. From the lender’s side, such financing structures are challenging. This is because the loan documentation needs to prescribe not only how the land and site will be developed using the loan monies, but also how the borrower should act under its project agreements and how it should exercise the buy-out so that it ultimately becomes the sole legal owner of the land and buildings in accordance with the project timetable.

First, such financing structures present a number of legal and commercial risks to lenders during the development period, namely the following:

- The municipality has the right to terminate (or not to renew) the lease with the developer, which, if exercised, may lead to a termination of the project. Lenders should also note that it is typical for the land lease to specify that the lease is terminated in the event of the developer’s liquidation.

- As well as lease rent (which is subject to annual review) and designed to cover the payment of land tax by the developer to the municipality, there are likely to be further expenses and fees payable by the developer. These could include infrastructure development contributions, which are quasi-mandatory contributions paid to the relevant municipal budgets.

- The developer cannot assign its rights under the land lease to any lender.

- The mortgage of land lease rights and the enforcement thereof are new to Ukrainian legislation and relatively untested.

- The acquisition of the state-owned land plot can take 24 months from the date of application, and there is no mechanism to compel the municipality to sell land.

Structuring the security package

There are considerable difficulties in obtaining full and effective security from a borrower during the construction period and before the borrower acquires ownership rights to the land.

Mortgages over land and buildings on the site

While recent changes to Ukrainian mortgage legislation appear to allow a land lessee to mortgage the land lease rights in favour of a lender, its enforcement remains unclear and the creation of such a mortgage would still require the involvement and cooperation of the municipality.

Assignment of project contracts

Although a lender would wish to have the benefit of all project contracts assigned to it as early as possible, the value of such security can only be properly realised once the borrower’s buildings on the leased land have been commissioned. Even at this stage, lenders should be aware that their security would be considerably improved if the borrower succeeded in purchasing the land plot (and granting a mortgage over the land to the lender).

Clearly, while the lease from the municipality is in force, even if the latter approves a mortgage of the land lease rights, the risk remains that the municipality could terminate the lease (albeit only for limited reasons) or, in a case of lessee default (enforcement of mortgage), could refuse to withdraw the land plot from the use of the original lessee and/or to grant new land lease rights to a lender. If a pledge of the borrower’s shares is contemplated, it is generally better if the borrower is a closed joint-stock company rather than a limited liability company.

Separate land lease owners and borrowers

A typical contractual structure for financings involving separate land lease owners and borrowers is set out in Chart 1. Developments sometimes use the same group company as a land lessee for the development of a number of municipal sites. This can lead to complications when some of the sites are already developed and/or have been financed by other lenders; in this event, the land lessee is likely to be unable to grant security over its assets or shares to a new lender at any stage of the financing. With this structure, a separate special purpose borrower company is often established in order to be the ultimate holder of all the interests in the land and buildings on a specific site. The idea is then that this new borrower company can eventually grant full security to a lender.
The land lessee is not entitled by law to assign or transfer its land lease rights to a third party, including a special purpose borrower. However, the market practice is that the land lessee and the new borrower company enter into an investment agreement providing for the land lease owner to enter into contracts and develop the land – ultimately for the benefit of the borrower – during the construction period. The borrower would make payments to the land lessee under the investment agreement and the land lessee would then agree to use such monies to develop the land with a view to eventually transferring all its interest in the land and the buildings on the site to the borrower.

Lenders should note that the transfer of the land lease from the land lessee to the borrower cannot be effected by way of assignment; the municipality must agree to terminate the existing land lease and enter into a new lease agreement with the borrower by means of a relevant municipal council vote and the adoption of a resolution indicating that the land plot is subject to withdrawal and the further transfer of the lease to a new land lessee.

**Structural measures to mitigate additional lender risk**

In this scenario, the lender is exposed to further counterparty risk with respect to the land lessee’s performance of its obligations under the investment agreement and otherwise. The EBRD’s experience shows that this further risk can be mitigated by using some or all of the following measures:

- As part of the documentation for the financing, the land lessee enters into a project support agreement with the lender pursuant to which it agrees to take all steps necessary in connection with the development of the site so that the borrower is able to comply with its loan agreement obligations to the lender.
- The borrower’s rights under the investment agreement with the land lessee are assigned to the lender.
- The sponsor’s guarantee includes a guarantee of the land lessee’s obligations under the investment agreement and project support agreement as well as a guarantee of the borrower’s obligations to the lender.

Where there is a separate land lessee and special purpose borrower company, contracts such as the general contractor agreement and leases to tenants of the site are entered into at the outset by the land lease owner with such contracts being ultimately for the benefit of the borrower. It is important for lenders that each project contract of this type gives the land lessee the right to assign its rights to the borrower or to insist on a novation in favour of the borrower simply by notice to the counterparty. Unless this assignment or novation right has been agreed at the outset, the lender is exposed to the risk that the counterparty will not consent to it later.

Lenders would typically want to receive a security assignment of the developer’s rights under the project agreements as a condition precedent to financing. While this may still be desirable, lenders should note that for legal reasons the land lessees may be unable to grant such an assignment and, as noted above, such security would have limited value prior to the commissioning of the site. If the project agreements are all to be novated at the time the site is commissioned then a lender could allow a further security assignment of the project agreement rights to the lender to be concluded at the time of novation.

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**Chart 1**

Real estate transaction in Ukraine: A typical contractual structure for financings involving separate land lease owners and borrowers
At the same time as the land property and the contracts are being transferred from the land lessee to the borrower, the developer (as a parent company of both transferor and transferee) should ensure that the real estate assets are transferred to the borrower in such a way that the borrower is correctly capitalised going forward and meets the lender’s test for debt-to-equity based on the then value of the real estate assets. This issue should be considered at the stage when the investment agreement is negotiated so that the borrower and developer have maximum flexibility under the investment agreement to ensure that these lender tests are met.

After novation and/or assignment of the project contracts to the borrower, the termination of the original land lease and the entry into a new lease between the borrower and the municipality and any other investment agreement actions have been concluded, the original land lessee should cease to be relevant and its obligations under the project support agreement with a lender should also end.

**Summary of security issues**

While there is a land lease from the municipality over the developed land, it is not possible to obtain effective security over the land other than the mortgage of land lease rights which, so far, remains undeveloped and is more commonly used as means of securing a negative pledge obligation. However, Ukrainian legislation permits mortgage over the uncompleted building during construction, and upon completion over the completed parts of the constructed property. Where there are different borrowers and land lessees, the project structure should also take into account the steps required to transfer the land lease and site interests to the borrower. It is common therefore for the lender to ask the sponsor to give a full corporate guarantee of the obligations of the borrower and its other relevant affiliates (such as land lessees) prior to commissioning of the site, the borrower acquiring the land from the municipality (see below) and the grant of effective full security over the land and site to the lender (financial and construction completion).

**Acquiring state-owned land**

In Ukraine land can be acquired, and disposed of, at land auctions initiated and administered by the local municipalities.

In terms of the site development, the land lessee enjoys a pre-emptive right to acquire the developed land plot or to extend the existing land lease agreement. At the same time, once the construction is completed and the building is commissioned, the land lessee acquires a right to purchase land without any auction process.

The purchase price is determined by an independent licensed appraiser appointed by the municipality pursuant to the Methodology of Expert Appraisal of the Land Plots approved by Resolution of the Cabinet of Ministers of Ukraine.

While it is common practice to apply for an acquisition of land in these circumstances (and there is no reason for a municipality not to cooperate in the sale), there is no absolute right of the land lessee under Ukrainian law to require the municipality to sell and to terminate its lease.

**Conclusion**

The EBRD anticipates concluding a number of municipal real estate financings in the coming months. The recent Ukrainian government commitment to large-scale developments on municipal land in the context of the European Football Championship in 2012 makes it clear that these types of transactions will assume a critical role in the future development of Ukraine.

The EBRD is keen to play its part as a financier: to help Ukrainian developers improve the infrastructure of the poorer areas of Ukraine while at the same time helping lawmakers and public sector bodies in Ukraine facilitate greater private sector ownership of land in accordance with internationally recognised standards.

Where there are different borrowers and land lessees, the project structure should also take into account the steps required to transfer the land lease and site interests to the borrower.
Notes

1 The new Land Code introduced the overall possibility of legal entities having the right to own land rather than the priority right to acquire it (though the general concept of private ownership was already guaranteed in the Constitution of Ukraine).

2 There are also non-commercial competitions that may be held by local authorities.

3 In Kiev, for example, it is now unusual for any lease to be longer than five years, although there are still 49-year land leases in existence.

4 Not all regions (cities) have their own development rules (which in any case should comply with the state legislation). Local development rules apply generally to the region (city) and provide for general development procedures.

5 According to Article 7 of the Law on Payment for Land dated July 3, 2007, No. 2535-XII, the land tax for such land plots should be 1.0 per cent of the normative value of the land (which value is often subject to annual review).

6 As a matter of law, a land lease may be mortgaged. However, the enforceability of leasehold mortgage appears to be questionable because the law does not specify the procedure of the land lease mortgage foreclosure. Furthermore, the foreclosure procedure implies, in fact, the transfer of land lease rights from the mortgagor to the mortgagee, which requires the consent of the owner of the mortgaged land parcel. In this case the land to be mortgaged is owned by the relevant municipality. Thus, transfer of the land lease as a result of enforcement of the mortgage would require the consent and cooperation of the municipality. Without the consent of the municipality, the transfer of a land lease to the mortgagee would be challengeable – although we understand that in practice municipalities will often cooperate in the execution of a new land lease agreement after the enforcement of the mortgage.

7 The enforcement of pledge of participatory interest in a limited liability company remains questionable and arguably would be possible only by means of foreclosure of a company’s assets rather than on the participatory interest itself. It should be noted, however, that pledge over participatory interests is very popular as (i) additional pledge and/or (ii) negative pledge.

8 Recent practice shows that most developers prefer to keep the development of each property done by a separate special purpose vehicle (SPV), which normally acts as a land tenant.

9 By law, granting a lease of land is subject to prior resolution of the local council.
Developing the Academy of Judges of Ukraine
The urgent need to create a national training system for judges in Ukraine has arisen from the demand for social and economic transformation and the creation and development of a democratic society. This article explores the issues surrounding the creation and future direction of such a training system.

As demonstrated by centuries of Western experience, creating a democracy cannot be achieved without establishing an effective, transparent and efficient judicial system. Creating a national training system for judges thus represents a commitment to developing democracy and affirming the rule of law in Ukraine.

In 2002, Ukraine’s Supreme Council (Parliament) and the President of Ukraine approved the establishment of a specialist higher educational institution – the Academy of Judges of Ukraine. Their decision was reflected in the Law on the Ukrainian Judicial System and in the Presidential Decree establishing the academy as an institution attached to the State Judicial Administration of Ukraine. Since its establishment, the academy has been offering professional development courses to judges and court and national judicial administration employees.

At the time of its establishment, the idea of creating a specialist educational institution for judges was not accepted at the national level; indeed, it was – to put it mildly – considered unwelcome by some members of the profession who saw this initiative as a threat to their independence. But although the academy started its operations in an atmosphere of mistrust, it managed not only to demonstrate its usefulness to the legal community, but also to exhibit the need for a country-wide judicial education system.

Since 2004, in addition to its head office in Kiev, the Academy has opened seven regional branches: in Dnipropetrovsk, Donetsk, Lviv, Odessa, Sevastopol, Kharkov and Chernovtsy. These regional branches have enabled the academy to extend its operations to the whole of Ukraine (see Table 1 on page 76).

In 2004, the academy introduced the practice of preparing an annual judge and court employee training schedule for the personnel of courts of all instances throughout Ukraine. This schedule includes all forms of training (seminars, teacher training, conferences, roundtable discussions) in Kiev and in the regional branches, both those which the academy offers independently and those that it offers jointly with donor and partner projects, programmes and organisations.

This practice allows the training process to be organised systematically, helps participants (judges and court officials) to plan their attendance in advance, and helps the academy to coordinate its efforts with those of its partners both in Ukraine and abroad. The draft schedule is submitted to the academy’s academic council and, after it has been approved by the council and confirmed by the academy’s director, it is sent out to all courts.
The academy offers training courses to:

- the presiding judges of local courts of general jurisdiction and their deputies
- the presiding judges of local economic courts and their deputies
- judges of administrative courts of all instances
- newly appointed judges of local courts of general jurisdiction and local economic courts
- judges of local courts of general jurisdictions in permanent posts
- managers of the administrative offices of local courts of general jurisdiction
- assistant judges and consultants to local courts of general jurisdiction and courts of appeal, as well as economic and administrative courts
- senior clerks of court and clerks of court employed by local courts of general jurisdiction and local economic courts
- court session secretaries employed by local and appeal courts of general jurisdiction and by economic courts
- bailiff service personnel
- specialists and heads of court departments dealing with judicial statistics, employed by courts of appeal, regional offices of the State Judicial Administration and military courts
- human resources specialists employed by courts and the regional offices of the State Judicial Administration.

Between 2003 and November 2007, some 6,132 trainees attended the academy’s professional development courses, including judges and court and State Judicial Administration employees (see Table 2, Item I).

This figure includes only trainees attending one-week and two-week seminars, based on standard curricula. These curricula determine the training programmes, their content and the number of teaching hours, which depends on the category of trainee. For judges it is 72 hours, with 38-54 hours for court administration and State Judicial Administration regional office personnel, also depending on their category. The standard curricula are the same for all the regional centres of the academy.

In addition to professional development courses, the academy offers short (one to five days) specialist seminars dealing with:

- topical procedural issues relevant to various categories of trainees
- seminars for judges elected to permanent judgeships
- seminars for judge candidates (started as an experiment in 2007)
- training courses for the academy’s teaching (training) judges.

Altogether in 2003-07 these specialist seminars were attended by 5,082 trainees (see Table 2).

As seen in Table 2, the total number of trainees attending the different courses offered by the academy was 11,214.

---

**Table 1**

<table>
<thead>
<tr>
<th>Office location</th>
<th>Area served</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kiev central office</td>
<td>This office coordinates activity in the whole of Ukraine, as well as providing training courses to the Vinnitsa, Zhitomir, Kiev and Chernigov provinces.</td>
</tr>
<tr>
<td>Dnipropetrovsk</td>
<td>Dnipropetrovsk, Zaporozhe and Kirovgrad provinces.</td>
</tr>
<tr>
<td>Donetsk</td>
<td>Donetsk and Lugansk provinces.</td>
</tr>
<tr>
<td>Lviv</td>
<td>Volynsk, Transcarpathian, Ivano-Frankivsk, Lviv and Rivne provinces.</td>
</tr>
<tr>
<td>Odessa</td>
<td>Nikolaevsk, Odessa and Kherson provinces.</td>
</tr>
<tr>
<td>Sevastopol</td>
<td>Autonomous Republic of Crimea and Sevastopol.</td>
</tr>
<tr>
<td>Kharkov</td>
<td>Poltava, Sumy and Kharkov provinces.</td>
</tr>
<tr>
<td>Chernovtsy</td>
<td>Chernovtsy, Khmelnitsky and Ternopol provinces.</td>
</tr>
</tbody>
</table>
In its selection of teaching and research personnel, the academy has been guided by the experience of similar judicial training institutions in western Europe, America and Asia, where trainees are taught mainly by working judges. For this reason, the academy’s teaching and research staff consists of working or retired judges and the best-qualified officials of the relevant ministries and departments. These include:

- judges currently working at Ukraine’s Constitutional Court, Supreme Court, and the Supreme Economic and Supreme Administrative Courts, as well as local courts and appeal courts of general jurisdiction
- retired judges
- the most experienced officials of Ukraine’s Ministry of Justice, the State Judicial Administration, the State Tax Administration and the Anti-monopoly Committee of Ukraine
- specialists from the Kiev Forensic Examination Research Institute
- leading Ukrainian and foreign legal experts.

Alongside its teaching activities, the academy undertakes research and carries out methodological studies whose main objective is to ensure uniform application of the law and to improve law enforcement procedures. The most recent work carried out by the academy jointly with the Supreme Court of Ukraine is as follows:

- summary of court practice relating to the examination of criminal cases involving human trafficking
- summary of court practice relating to “not guilty” verdicts and the grounds for their reversal. The results of this work have been presented to a plenary session of the Supreme Court of Ukraine
- summary of court practice relating to community service sentences. The results of this work have been presented to a plenary session of the Supreme Court of Ukraine
- summary of documents relating to professional ethics compliance by judges provided by the Supreme Judicial Qualifications Commission of Ukraine.

The academy’s representatives regularly attend inter-university and international conferences, and the academy itself organises scientific and practical conferences to which it invites leading Ukrainian and foreign experts.

The academy’s international activities are aimed at acquiring funding and attracting the best international experts to address relevant issues relating to judicial training in Ukraine. To this end, the academy forges links with international organisations, international technical assistance projects, the embassies of countries accredited in Ukraine and similar institutions abroad.

### Table 2

<table>
<thead>
<tr>
<th>Item</th>
<th>Seminar type</th>
<th>Number of trainees 2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Total (2003-07)</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Professional development seminars for judges, court administration</td>
<td>154</td>
<td>843</td>
<td>1,497</td>
<td>1,740</td>
<td>1,898</td>
<td>6,132</td>
</tr>
<tr>
<td></td>
<td>and State Judicial Administration regional office personnel</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>II</td>
<td>Specialist seminars for various categories of trainees</td>
<td>118</td>
<td>1,133</td>
<td>1,433</td>
<td>1,233</td>
<td>1,103</td>
<td>5,020</td>
</tr>
<tr>
<td>III</td>
<td>Training for judge candidates (one-day seminars conducted as an experiment)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>62</td>
<td>62</td>
</tr>
<tr>
<td>TOTAL</td>
<td>(I+II+III)</td>
<td>272</td>
<td>1,976</td>
<td>2,930</td>
<td>2,973</td>
<td>3,063</td>
<td>11,214</td>
</tr>
</tbody>
</table>

The academy forges links with international organisations, international technical assistance projects, the embassies of countries accredited in Ukraine and similar institutions abroad.
The academy has been involved, as either an initiator or a participant, in virtually all major international programmes and projects supporting democratic transformations in the area of judicial reform in Ukraine.

Establishing a European-style judicial training system

The academy has prepared a conceptual document entitled The National System of Training, Retraining and Professional Development for Judges and Court and State Judicial Administration Personnel, which was approved by the Board of the State Judicial Administration of Ukraine in 2004.

The document divides the objectives of the national judicial training system into short-term, medium-term and long-term goals.

The long-term goal is the establishment of a national judicial training system, providing an efficient mechanism for:
- implementing the principle of the rule of law
- enhancing the administrative capacity and robustness of the judicial system
- preparing the judicial system for Ukraine’s possible integration into the EU.

Achieving this long-term goal will require the development of an holistic, integrated and systematic approach to judicial training. It will also need the designation and support of the academy as the sole training institution capable of developing and implementing a national strategy of judicial training; the accumulation of teaching and financial resources; the development of a unified methodical and methodological framework of judicial training; and the provision of the research support required for its future development.

The medium-term goal is to reduce the percentage of rulings reversed by courts of higher instance, to reduce (as far as possible) the length of judicial procedures and to increase the efficiency of judicial administration.

Achieving this goal will require the development of a judicial training system that is capable of enhancing the theoretical knowledge and practical skills directly linked to the social changes associated with Ukraine’s socio-economic reform.

The short-term goal is to deal with the current difficulties of the administration of justice as they arise.

Achieving this short-term goal will require the sensitive and flexible management of the day-to-day planning and implementation of the training process.

The conceptual document further proposes the creation in Ukraine of a European-style judicial training system, which in most countries is based on the French model.

The European experience of the selection and training of judges demonstrates that European principles of judicial training, while not spelled out, do exist and are being successfully applied. The first principle is that the state has sole responsibility for judicial personnel training. The second principle relates to the training of judges in specialised institutions: these institutions have different names in different European countries, but are always the agencies authorised to select and train judges. In addition,
Developing the Academy of Judges of Ukraine

The assessment procedure itself is very complex and requires candidates to have considerable theoretical and practical knowledge. These schools receive up to 40 applications for each place. However, the main point is that future judges spend two to three years being trained in these institutions under the constant supervision of both the judges themselves and of psychologists and lecturers, and become highly qualified specialists during this period.

The essence of this model has been recreated in the Concept for the improvement of the judicial framework to reinforce fair court proceedings in Ukraine in accordance with European standards. This document was drafted by the National Commission on the Consolidation of Democracy and Confirmation of the Rule of Law and was approved by Presidential Decree in 2006.

The Presidential Decree marked a new stage in the development of the national system of judicial training, and the academy, as the institutional component of this system, must play a key role in this process.

The document officially recognises the need to introduce specialist professional training for judge candidates, designed to provide future judges with practical professional skills. This training will be offered by the academy. Achieving this objective will require amending the Laws on the Status of Judges and the Ukraine Judicial System – the proposed amendments have been drafted with the participation of the academy and have been submitted to the Supreme Council of Ukraine.

Major changes will also be required in the system for selecting judges, which is at present cumbersome, multi-layered and lacking in transparency, and as a result does not attract the best candidates. For this reason the academy is now working on the introduction of new procedures which will ensure competitive selection of the best candidates by using anonymous testing, and by getting to know the candidates during the period of their training and work placements.

The academy has already taken its first steps towards this goal, by developing a judge candidate testing, assessment and selection system. The first stage of this process has included preparing a programme which allows the candidates to study independently, covering different branches of the law, tests and situational problems. The system has already gained preliminary approval, having been introduced as a pilot project in four regions, in close cooperation with the Supreme Judicial Qualifications Commission of Ukraine.

An interesting point is that those achieving the best results in the experimental tests were judge candidates currently employed as assistant judges. This outcome has served to reaffirm the need for the introduction of special training for future judges at a specialist institution such as the academy. The training process should include a period of work experience in courts, to enable candidates to obtain a specialisation.

This approach will support the improvement of judicial procedures and strengthen fair court proceedings in line with European standards. These are the ideas underlying the proposed amendments to the Laws on the Status of Judges and the Ukraine Judicial System referred to above.

There is one further point to be made. At present in Ukraine there is no requirement for judges or court employees to attend professional development courses. Training is completely voluntary, and participants are recruited in accordance with the need for training and the court authorities’ awareness of this need. What is more, there is no direct link between continuing education and career prospects.

The Concept for the Improvement of the Judicial Framework to Reinforce Fair Court Proceedings in Ukraine in Accordance with European Standards, and the resultant draft Laws on the Status of Judges and the Ukraine Judicial System, envisage the introduction of mandatory professional development and a direct link between such developments and career prospects.
The above objectives can largely be achieved and the academy transformed into a truly European-style training institution for judges by making the following provisions:

- reinforcing the academy’s special status in line with European standards, with the core component of its status being subordination to the judiciary
- recognising mandatory training of judge candidates at the academy for a period of at least one year as an integral component of the judge selection mechanism
- recognising the judges’ right and duty to participate in retraining and professional development, and establishing a direct link between training and professional advancement and the chance of election to a permanent judgeship
- defining in legislation the status of working or retired judges who are teaching at the academy, and in particular providing for the secondment of working judges to the academy for specified periods of time without loss of their existing position or salary (for periods of six months to a year)
- legislatively defining the special status of the academy’s other research and teaching personnel
- establishing a supervisory board to act as the academy’s special body, with the function of developing and monitoring the implementation of the national judicial training policy. The board should consist largely of members of the judiciary
- implementing of supervisory board resolutions relating to the preparation and approval of teaching programmes, standard curricula and so on should be entrusted to a special body – the academy’s academic council
- confirming the academy’s status as the leading judicial research institution, with the task of providing scientific support for the development of Ukraine’s judicial system.

The establishment of the academy has been recognised by experts from the Council of Europe as an extremely positive development.

The competence of the judiciary can only be based on the high professional standards of judges, who are the bearers of its authority, as expressed by the level of their qualifications and determined by their theoretical training, professional competence, a desire to see justice prevail and a sense of personal and professional dignity.
A major effort will be needed to make judicial training in Ukraine systematic and unified. The establishment of the academy has been recognised by experts from the Council of Europe as an extremely positive development, signifying the goodwill of the state and guaranteeing every judge the right to achieve a high level of professional skills. It has also been welcomed by judges, who see the academy as an institution established to meet their need for professional development and to deliver programmes organised at their request.

Notes

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Promoting Corporate Governance in Ukraine: Adding value to the private sector through advisory services
Corporate governance is a relatively new topic in Ukraine, yet interest is growing as businesses become increasingly aware of the benefits that good corporate governance can bring. The International Finance Corporation (IFC) has promoted corporate governance in Ukraine since the mid-1990s and is well-versed in the challenges and issues of implementing corporate governance practices there. This article provides a snapshot of corporate governance issues in Ukraine today and the IFC’s approach in addressing them through advisory service projects.

Corporate governance is the system by which companies are directed and controlled. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside sources of capital. Therefore, it should come as no surprise that corporate governance is an important factor affecting the development of the private sector in transition economies, such as Ukraine.

More than 15 years after independence, there have been some improvements in corporate governance, but Ukraine still lags behind many of its post-Soviet neighbours. According to the most recent World Bank/IFC Doing Business report, Ukraine ranks only 141st out of 178 countries with respect to investor protection. Transparency International’s 2007 Corruption Perceptions Index ranks Ukraine 118th of 180 countries worldwide.

Among the priority actions identified for Ukraine by international experts, the most commonly mentioned is the need for an improved regulatory framework – a new law on joint-stock companies (JSCs), which establishes clear rules regarding director liability, transparency and disclosure – and the protection of minority shareholder rights.

Lack of a legislative framework

Currently, companies in Ukraine are governed by the Law on business associations adopted in 1991. This law regulates the activities of five different types of companies, including JSCs. However, it is far from adequate as there are more than 30,000 JSCs in Ukraine but only 26 articles regulating them in the law. A step in the right direction was made with the adoption of new civil and commercial codes, in force from January 2004, which included a few provisions relating to corporate governance.

Unfortunately, they remain contradictory to each other and create more questions than clarity for Ukrainian companies.

Over the past decade there have been numerous attempts to pass a new law on JSCs, but these attempts have been thwarted by forces in parliament that were concerned about how transparency and fair rules would negatively affect their personal businesses. A draft Law on joint-stock companies was finally adopted on its first reading in May 2007. This draft introduces a number of progressive corporate governance practices for Ukraine, such as cumulative voting, clearer share-acquisition procedures and rules to deal with related-party transactions and conflicts of interest. Yet, although the draft introduces some best practices, in most cases there are no proper mechanisms in place to implement them and many of these rules would not apply to closed JSCs, which are even less transparent than open ones. Therefore, the draft law is seen as a compromise between oligarchs, who own many closed JSCs, and progressive Western-oriented businessmen. Nonetheless, this draft law is recognised as an important step towards improving corporate governance in Ukraine.
In addition to a weak legislative framework, Ukraine also has an ineffective court system, which creates problems in enforcing the country’s few existing corporate governance rules.

Weak enforcement and an underdeveloped market

In addition to a weak legislative framework, Ukraine also has an ineffective court system, which creates problems in enforcing the country’s few existing corporate governance rules. The low level of corporate governance expertise among judges, together with less-than-perfect legislation, leads to contradictory decisions and a significant number of appeals. Furthermore, in corporate disputes, ambiguous laws and inconsistent practices often escalate conflicts. According to the 2006 annual report of the Securities and Stock Market State Commission of Ukraine (SSMSC), these problems result in a lack of uniform application of the law and delay the exercise of sanctions by the commission.

According to a recent IFC study on commercial dispute resolution, Ukrainian businesses are generally not satisfied with judicial proceedings and reported that, in their most recent business disputes in court, the court decision was only completely adhered to in 45 per cent of cases, partially adhered to in 18 per cent of cases, and not adhered to at all in 37 per cent of cases. When asked what factors were important to businesses when selecting a dispute resolution method, 58 per cent of respondents stated that the most important factor was obtaining an outcome that could be enforced. Unfortunately, there are no functional alternatives to court litigation for resolving commercial disputes in Ukraine today.

In a country where capital markets are still underdeveloped, market forces do not have much effect. The largest stock exchange in the country, the First Fund Trading System (PFTS) index, has only around 135 listed companies, of which only a small percentage are actively traded. Self-regulating organisations in Ukraine are, for the most part, passive in promoting good corporate governance standards. However, the PFTS is planning to introduce new listing rules requiring increased disclosure and transparency.

Violations of shareholder rights

According to the 2006 SSMSC annual report, the level of corporate conflicts in Ukraine remains the same as for the previous year. Inadequate corporate legislation, weak enforcement and the absence of reliable mechanisms for ownership registration and transfer are listed as the key reasons for the lack of improvement. The SSMSC refers to a significant number of violations on the market, primarily violations of shareholders’ rights during additional share issuances (share dilution resulting from issuing additional shares at below fair market value), asset stripping (the sale or transfer of company assets by management to a related party for below fair market value), violation of shareholders’ right to information and the right to call an extraordinary general meeting, and a very low level of information disclosure. Furthermore, the media has been reporting a new wave of hostile takeovers and corporate raider attacks, and the government’s recent attempts to keep them under control have been unsuccessful.

A progressive corporate governance code

In the absence of a law, the SSMSC, as the main market regulator, decided to adopt a set of national corporate governance principles for Ukraine in December 2003. Based on the OECD’s Principles of Corporate Governance, this is a voluntary code designed primarily for open JSCs. It was adopted after a lengthy drafting and public consultation process to ensure private sector feedback and buy-in. In addition, the SSMSC also adopted a sample charter and by-laws to provide guidance to companies on how to incorporate the main provisions of the principles. According to the SSMSC, almost 70 per cent of companies have already revised their corporate documents to include elements of these principles.

While this voluntary code is a good start, it is not enough. In such an environment, companies need additional guidance on how to improve corporate governance practices to allow them to attract investment and operate more effectively. Good corporate governance is one factor that can help differentiate good companies from others: a company that invests in corporate governance increases its profile and has a better chance of attracting investment.
The IFC in Ukraine

The IFC has been active in Ukraine since the early 1990s. As a member of the World Bank Group, the IFC’s mission is to reduce poverty and improve people’s lives by promoting sustainable private sector investment in developing countries. As of 30 June 2007, the IFC has invested US$ 742 million in 35 projects in Ukraine in a variety of industries, including finance, retail gas operations, distribution, warehousing and logistics businesses, steel and juice production. The IFC also plays an active role in providing advisory services to the private sector in key areas such as agribusiness, leasing, housing finance, regulatory simplification and corporate governance.

The IFC’s approach to promoting corporate governance

Corporate governance has always been a priority for IFC: it allows it to manage risks as an investor and to add value to clients as a development institution. Improving corporate governance also contributes to the development of public and private capital markets by promoting transparency and helping to increase investment in developing countries.10

In its work on corporate governance, the IFC has taken a comprehensive approach, addressing corporate governance issues at various levels and with a wide variety of stakeholders. This approach has included working with companies and banks on improving practices, with the government on policy reform, transferring knowledge and materials to educational institutions and raising public awareness about the importance of good corporate governance (see Chart 1). The IFC’s corporate governance projects typically last three to five years and are delivered by project teams that consist of an expatriate project manager and local professionals with backgrounds in law, accounting, audit and finance.

IFC has learned that a comprehensive approach works and an independent assessment has confirmed that addressing issues like corporate governance at many levels “helps ensure lasting and far-reaching results”.21

Working with the SSMSC and the National Bank of Ukraine, the IFC has provided advice on, or assistance in drafting, 29 policy documents, of which 12 have been adopted thus far. These include the Principles of corporate governance for Ukraine and the Methodological recommendations on corporate governance for banks. The IFC has trained 330 lecturers at 56 educational institutions across the country, ensuring that over 23,000 students on 200 different courses annually are taught using materials developed by them. This ensures that knowledge and information on corporate

---

**Chart 1**

A comprehensive approach to promoting good corporate governance

- **International Finance Corporation (IFC)**
  - **Company operations**
  - **Policy reform**
  - **Public awareness and educational work**

- **Enables companies to change practices; demonstration effect**
- **Provides appropriate regulatory framework**
- **Drives demand for better practices**

Source: IFC
governance is passed on to the next generation of managers, directors and business leaders. However, the crucial part of the IFC’s work has focused on providing corporate governance advice to private sector companies and banks.

The pilot programme

Although over 3,000 managers from companies and banks attended IFC training events on corporate governance, a limited group of companies was selected through a competitive process to participate in a comprehensive pilot programme. To date, 28 companies and six banks have completed the programme. The pilot programme begins with an assessment of the client’s corporate governance practices by reviewing various documents and interviewing members of the board, managers and shareholders.

The IFC’s methodology in conducting these assessments is the same as the one developed to assess the corporate governance of its investment clients. The core tool is a progression matrix (see Chart 2) using five key attributes of corporate governance (commitment, board of directors, control environment, transparency and disclosure and shareholders) and four levels from “acceptable” to “leadership”. There are four different versions of the matrix – for listed companies, family-owned/unlisted companies, financial institutions and transition economies – reflecting the key types of companies with which the IFC works.¹²

A corporate governance assessment report was then prepared and presented to the company’s management and board. Staff worked with directors and managers to decide which issues should take priority and helped to develop an improvement plan, which was then implemented over several months with assistance from IFC’s project team.

Work often included: tailored workshops and orientation sessions for boards of directors; assistance in revising corporate documents to bring them in line with international standards; help in organising shareholder meetings; advice on effective corporate structures and meetings; development of the role of corporate secretary; encouraging the election of independent directors; and assistance in improving financial reporting and information disclosure. After key elements of the improvement plan were implemented, the company received a summary of the work with recommendations on further steps it could take to continue developing its corporate governance.

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Levels</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitment to good corporate governance</td>
<td>1. Acceptable</td>
</tr>
<tr>
<td>Structure and functioning of the board of directors</td>
<td>2. Extra steps</td>
</tr>
<tr>
<td>Control environment</td>
<td>3. Major contributions</td>
</tr>
<tr>
<td>Transparency and disclosure</td>
<td>4. Leadership</td>
</tr>
</tbody>
</table>

Source: IFC

Chart 2
Progression matrix for corporate governance practices – a client orientation and self-assessment tool

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Levels</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitment to good corporate governance</td>
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</tr>
<tr>
<td>Transparency and disclosure</td>
<td>4. Leadership</td>
</tr>
</tbody>
</table>

Source: IFC

Chart 3
Motivating factors for companies undertaking corporate governance improvements
The rationale behind providing such in-depth direct assistance to companies and banks was to improve their current corporate governance with the hope that these improvements would show short and long-term benefits, such as attracting investment, streamlining decision-making, reducing corporate conflicts and increasing efficiency. The success stories of these pilot companies were then publicised to create a demonstration effect in the market, so that other companies would see the rewards of improved corporate governance and hopefully decide to follow a similar path of reform.

This demonstration effect turned out to be a key component of the IFC’s work (see Chart 3). In recent surveys conducted by the IFC in Ukraine, both companies and banks indicated that the practices of other corporations were one of the top factors that motivated them to improve corporate governance. In the corporate sector, seeing the changes made by other companies was the number one motivator among non-IFC clients and the second motivator, after legislation, among IFC clients. In the banking sector, improvements made by other banks were cited as the number one motivator.

Another success of the pilot programme was that many of the companies taking part were able to use the corporate governance improvements to obtain significant financing. During the life of the projects, pilot companies and banks attracted over US$ 950 million of investment as a result of improving their corporate governance practices, and only US$ 55 million of this came from the IFC.

Given that it is usually some time before benefits are reaped from such improvements, it is hoped that the impact of this work will increase over time. But these early results already send a strong message to the market that there is a link between better corporate governance and access to finance. Furthermore, the IFC charged banks for the corporate governance pilot programme and collected US$ 230,000 in fees. This means that the local market is starting to understand this link and is prepared to pay for corporate governance services.

The IFC regularly monitors and evaluates its advisory services work by conducting impact assessment surveys and tracking the progress of various initiatives during and after projects. In addition to investment, many companies reported other benefits to strengthening their corporate governance, such as improved decision-making, improved production, sales or profits, improved reputation and reduced conflicts (see Chart 4).

Box 1 shows a case study of a Ukrainian company that used IFC help to improve its corporate governance practices and, thereby attract more international finance for its expansion plans.
A long process

Corporate governance is a journey, not a destination. Moreover, in the former Soviet bloc, it demands a change of culture and mindset. Fewer than 20 years ago there was no private sector in Ukraine. Therefore, while the IFC’s projects have been largely successful, much work still needs to be done to improve corporate governance practices in Ukraine.

A critical issue is the need for a new law on JSCs as it is difficult to make the business case for corporate governance in the absence of a solid legal framework. It is hoped that the current parliament will continue to support the adoption of this important law. In parallel, judicial reform is needed to ensure that laws and regulations affecting corporate governance will be enforced. More stringent listing rules by stock exchanges can also play an important role in setting the corporate governance agenda.

Another important driver is the demand by investors for good corporate governance from the companies in which they invest. In October 2007, 31 development finance institutions, including the IFC and the EBRD, signed a statement on a common commitment to improving the corporate governance of their investee companies. Such actions send a clear message to developing markets that corporate governance is important and emphasise the link between good corporate governance and access to finance.

Much work still needs to be done to improve corporate governance practices in Ukraine.
Notes

5. Open JSCs have many features common to public companies but their shares are not necessarily listed on a stock exchange. Closed JSCs have certain characteristics of private companies, such as restrictions on alienation of shares, but they may have as many shareholders as open JSCs.
10. See footnote 2.

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Joint-stock companies in Ukraine: changes in the legislative framework
This article presents the current state of affairs and the forthcoming changes in the legal regulation of joint-stock companies in Ukraine. It reviews the draft legislation currently under discussion and the implications of its provisions, should they become law.

Ukraine is a country full of surprises. One would hardly imagine that the country’s approximately 36,000 joint-stock companies (JSCs) generating the most significant share of its GDP are still governed by a small part of an obsolete Companies Law dated back to the early 1990s! Especially surprising is that if we compare it with neighbouring Moldova – with only half the population of the city of Kiev – which has had a second version of its comprehensive JSC Law in place for almost a decade.

**Historical perspective**

The Ukrainian parliament adopted the Companies Law in September 1991. After many decades of communist rule, this was the first attempt to set out a basic framework for independent economic activity in the country. The law introduced five legal forms of doing business in Ukraine – JSCs, limited liability companies (LLCs), additional liability companies, full partnerships and limited partnerships.

Over the years most of the state-owned Soviet-era enterprises and other unconventional organisational forms of economic activity in the country have disappeared, while most of the company types, other than JSCs and LLCs, have proved to be unviable. As a result, most business entities in the country today are organised either as a JSC or a LLC.

Two thirds of approximately 36,000 JSCs are “closed” meaning that their shares may not be publicly placed or sold on a stock exchange. The remaining ones, which represent the best of the Ukrainian economy, are “open” JSCs. Their shares may be publicly placed and/or traded at a stock exchange.

As indicated, regulation of JSCs in Ukraine dates back to 1991, when the country had virtually no experience of setting up the rules of the game on independent economic activity, let alone regulating such complex economic organisms as JSCs. As a result, the relevant section of the Companies Law addressed only very basic issues, creating more problems for the future than it resolved at the time. For example, the law said nothing about the protection of minority shareholders. It failed to provide for the reasonable distinction between open and closed JSCs. As a result, unruly monsters, having thousands of shareholders, came to life in Ukraine as closed JSCs.

The law also failed: to regulate properly the procedure of alienation of shares in JSCs; to regulate the procedure of forming their governing bodies and the allocation of corporate authority among them; to establish reasonable quorum and voting requirements for various types of JSCs; to create a legislative model for transparent and effective corporate governance structures; and to introduce rules on self-dealing with respect to the JSCs officials, among other things. The issue of maintaining corporate registers became notorious in Ukraine as the lack of its proper legal regulation created lucrative grounds for flourishing of numerous corporate raiders in the country.

The Ukrainian legislator attempted to fill in the most obvious gaps in the legal regulation of the above practices by adding relevant sections to the new Civil Code of Ukraine (Civil Code) and the Commercial Code of Ukraine (Commercial Code). In addition, the Securities and Stock Market State Commission (SSMSC) – the Ukrainian securities markets regulator – has adopted numerous regulations aimed at streamlining JSCs operations.
However, many or all of the above modifications created only more confusion in the market. Notably, the Civil Code and the Commercial Code contain somewhat overlapping and ambiguously formulated rules with respect to the same or similar matters. That mere fact creates confusion not only between each of the codes and the Companies Law, but also between the codes themselves. Thus, the simultaneous existence of those two codes adds uncertainties and ambiguities to Ukrainian corporate law, which complicates everyday lives of Ukrainian businesses.

In addition, the SSMSC often attempts to regulate certain legal matters in blatant contrast to the letter of law. For example, in the instances where specialised securities laws of Ukraine specifically require the application of qualitative criteria, the SSMSC in its regulation tries to use quantitative criteria. Moreover, the Civil Code introduced certain rules, which were clearly not logical and reasonable from an economic perspective. For example, it made JSCs subject to mandatory liquidation if their equity decreased below certain statutory minimum charter capital threshold. Such a drastic rule may affect almost every start-up JSC and especially JSCs engaged in business which involves significant initial costs and delayed returns (for example, the construction sector). The risk of breaching the low equity rule is of significant concern for all investors – whether domestic or foreign – intending to do business in Ukraine. There are several other examples of rules introduced by the Civil Code, Commercial Code and/or the SSMSC, which have no obvious economic rationale behind them.

This situation does not improve the stability of the legal regime governing JSCs. Neither is the resolution of such ambiguities a routine matter. It usually requires the engagement of qualified legal professionals, with the associated additional time and financial costs, for businesses to resolve such controversies. Hence the need for a new and comprehensive law governing all aspects of JSC activity in Ukraine.

Quo vadis, Ukraine?

The adoption of this new set of rules has been hotly debated at various levels of the Ukrainian government, among legal professionals and businessmen since mid-1990s. In 1998, an initial draft Joint-stock Companies Law was put together and published for public discussion. Since then it has been redrafted nearly a dozen times with several iterations developed by various business and legal groups.

The most recent version of this draft law was officially submitted to the Ukrainian parliament in February 2007 for its consideration and adoption. On 15 May 2007, the Ukrainian parliament attempted to pass it through at the first reading. This was controversial as the President of Ukraine had already issued and promulgated his decree disbanding Ukrainian parliament, thus rendering it legally incapacitated. The draft law has yet to be analysed and worked through by a Ukrainian parliament committee. Similarly, it has yet to be heard by a legitimate and legally capable Ukrainian parliament.

The new Ukrainian parliament only began working at the very end of November 2007, so it is very unlikely that the draft law will be passed during the first half of 2008. Moreover, given the fact that the provisions of law remain controversial and are seen as too revolutionary for many in the new Ukrainian Parliament, it is difficult for us to predict what shape the draft law will take once it has been examined by the committee, or even after its initial reading in Ukrainian parliament.
We have reason to suspect that the draft law will be applicable only to open JSCs, which will be converted into so-called public JSCs (see next section). Hence, it will not apply to almost 22,000 closed JSCs, which will continue to be governed by the obsolete and controversial current corporate legislation of Ukraine. Moreover, it looks like approximately 11,000 open JSCs will, in fact, be allowed to stay in their current form (and be converted into public JSCs) or re-register as closed JSCs (which would be subject to the above exemption).

That scenario could undermine the whole purpose of reforming corporate legislation governing JSCs in Ukraine. If it does not materialise, however, Ukraine could make huge leaps forward in resolving the problems already discussed, setting up clear and transparent rules for JSCs, making them more investor-friendly, introducing modern concepts and ideas from Western jurisdictions and, generally, bringing Ukrainian corporate legislation closer to that of the European Union.

Below is an attempt to see whether the current version of the draft law attempts to meet all or any of the above goals.

**Selected new concepts and rules**

The draft law suggests cancelling the current distinction between open and closed JSCs. Closed JSCs would be allowed to exist for five more years and then would be required either to acquire the status of regular (open) JSCs or to be converted into LLCs or another legal form of organisation. The draft law leaves JSCs with no choice but to have their shares publicly traded and subscribed in public offerings.

Instead, of the open/closed distinction, the draft law suggests the division of JSCs into public and private categories. Public JSCs would be authorised to carry out both private and public placements of their shares. They would also be required to be listed with at least one stock exchange. All shares of a public JSC would be freely transferable. Private JSCs would only be authorised to carry out private placements of shares and their corporate documents could provide for certain restrictions on the transferability of their shares, for example, the right of first refusal of existing shareholders with respect to shares offered by their peer shareholders. It is expected that the effective elimination of closed JSCs from the Ukrainian legal field will be one of the most controversial points of debate in Ukrainian parliament, because of the lobbyists representing closed JSCs there.

Another important novelty of the draft law is the suggested increase of the minimum charter capital required for the establishment of a JSC to 2,500 statutory minimum salary (currently 1,250 statutory minimum salary which is approximately €80,000 at present exchange rates). Given that the minimum salary is not a constant number and is gradually increasing, the initial investment into the charter capital of a JSC may turn out to be quite significant and to be subject to frequent changes.

The draft law sets out elaborate rules regarding the rights of shareholders holding ordinary and preferred shares, among other things, regarding participation in the governance of the company, distribution of profits, liquidation proceedings and so on. The draft law also introduces rules on the protection of shareholders who are employed by the company, in particular to protect such shareholders from influence by the company’s management and other officials.

The draft law purports to introduce more elaborate corporate governance rules and models. It broadens the authority of a JSC’s supervisory board. It also provides for the possibility of creating committees within the supervisory board and introduces the office of a corporate secretary, which is a novelty in Ukrainian corporate law.

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The draft law decreases the quorum requirement for the general meeting of shareholders making it equal to more than 50 per cent of the total number of the voting shares as compared to the current threshold of more than 60 per cent. Apparently, the decrease of the quorum threshold favours majority shareholders, who will effectively be able to control the JSC by being able to avoid the blocking tactics often used by minority shareholder(s) now. To counterbalance that, the draft law provides for the introduction of the cumulative voting on certain corporate issues (for example, election of supervisory board members), which should ensure the protection of the minority shareholders and allow them to have representative(s) in the governing bodies of a JSC.

The draft law also contains a rule which requires the involvement of shareholders, at the level of the general shareholder meeting, or a supervisory board when deciding on the conclusion of material transactions (a percentage threshold to the assets of a JSC is established) or transactions with an interested party (self-dealing transactions).

Finally, the draft law contains more detailed regulation on the reorganisation and liquidation of a JSC as compared to the current corporate rules.

So far as the application of the new rules to existing JSCs is concerned, the corporate documents of existing open JSCs will have to be made compliant with the new rules within five years. These documents will only remain valid if they do not contradict the newly established rules.

The draft law provides for a person who acquires the material shareholding in a JSC (50 per cent or more of the voting shares) to acquire the shares of the remaining minority shareholders at market price. It is expected that this will cause significant debate in the Ukrainian parliament.

It is impossible to be certain which of the above novelties will ultimately find their way into the final text of the law. Some of them may not survive parliamentary readings, others may be significantly modified, while completely new ones may appear by the end of its parliamentary lifecycle. However, it is important that the primary goal is not lost – the new legislation must be clear, transparent and aligned with European norms and should be aimed at facilitating the lives of investors and businessmen in Ukraine. Moreover, it should be aimed at regulating all JSCs irrespective of their current legal status – whether open or closed. Otherwise, it will be difficult to see how business entities generating the most GDP will be capable of ensuring further sustainable development of the Ukrainian economy while their investors (both domestic and foreign) remain attracted by the legal terms and conditions of their investment activity. The solution is already long overdue.
Notes

1 For example, Article 1 of the original version of the Law on State Regulation of the Securities Markets in Ukraine specifically provided that a person/entity was deemed to be engaged in professional activity in the securities markets if the activity was the only or the most significant part of their business activity, that is, it set up qualitative criteria for the definition of the professional activity on the securities market. In blatant contrast with the above requirement of law, the SSMSC in its Decision No. 7 of 14 May 1997 provided for the following definition of the professional activity on the securities market: "a natural person will be deemed to engage in professional activity on the securities markets if he/she enters into contracts the value of which exceeds 1,000 minimum monthly non-taxed income". The similar definition applicable to legal entities provided for a 10,000 minimum monthly non-taxed income threshold.

2 For example, the requirement of Article 155 Paragraph 3 of the Civil Code to decrease the charter capital of a JSC if upon the expiration of the second and any subsequent year of its existence the value of its net assets shrinks below the value of its charter capital, or the introduction of a separate legal category of a “foreign enterprise” by the Commercial Code of Ukraine to identify Ukrainian business entities 100 per cent owned by foreigners – one can hardly imagine how that concept can be applied to open JSCs.

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<table>
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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>AFSA</td>
<td>Albanian Financial Supervisory Authority</td>
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<td>BEEPS</td>
<td>Business Environment and Enterprise Performance Survey</td>
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<td>CEB</td>
<td>Central European and Baltic states</td>
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<td>CEE</td>
<td>Central and eastern Europe</td>
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<tr>
<td>CIS</td>
<td>Collective investment schemes</td>
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<tr>
<td>CIS+M</td>
<td>Commonwealth of Independent States and Mongolia</td>
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<td>EBRD, the Bank</td>
<td>European Bank for Reconstruction and Development</td>
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<td>EIB</td>
<td>European Investment Bank</td>
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<td>EU</td>
<td>European Union</td>
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<td>FDI</td>
<td>Foreign direct investment</td>
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<td>FSAP</td>
<td>Financial Sector Assessment Programme</td>
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<td>FSFM</td>
<td>Federal Service for Financial Markets</td>
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<td>FYR Macedonia</td>
<td>Former Yugoslav Republic of Macedonia</td>
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<td>GDP</td>
<td>Gross domestic product</td>
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<tr>
<td>GWP</td>
<td>Gross written premiums</td>
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<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<td>IOPS</td>
<td>International Organisation of Pension Supervisors</td>
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<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IPO</td>
<td>Initial Public Offering</td>
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<td>IRIS</td>
<td>Insurance Regulatory Information System</td>
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<td>ISDA</td>
<td>International Swaps and Derivatives Association</td>
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<td>JBIC</td>
<td>Japan Bank for International Cooperation</td>
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<td>LIS</td>
<td>Legal Indicator Survey</td>
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<td>MEDT</td>
<td>Ministry of Economic Development and Trade</td>
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<td>MBBs</td>
<td>Mortgage-backed bonds</td>
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<td>MEI</td>
<td>Municipal and environmental infrastructure</td>
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<td>MIS</td>
<td>Management information system</td>
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<td>MPCs</td>
<td>Mortgage participation certificates</td>
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<td>NCFM</td>
<td>National Commission of Financial Market</td>
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<td>SSMSC</td>
<td>Securities and Stock Market State Commission</td>
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<td>SEE</td>
<td>South-eastern Europe</td>
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<td>SFC</td>
<td>Special finance company</td>
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<td>SPV</td>
<td>Special purpose vehicle</td>
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<td>SROs</td>
<td>Self-regulatory organisations</td>
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<td>UN</td>
<td>United Nations</td>
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<td>UNCITRAL</td>
<td>United Nations Commission on International Trade Law</td>
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<td>WTO</td>
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Law in transition is printed on Hannoart Silk, an environmentally responsible paper which is 100% TCF (Totally Chlorine Free).

Printed in England by Moore using environmental waste and paper recycling programmes.

Ref: 7133 Law in transition 2007 (E).

ISSN 1683-9161

www.ebrd.com/law