

KEEPING SECURE

Regulation becoming more effective as securities market develops

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The past several years have seen the development of a Ukrainian securities market and, in response, more effective regulation governing that market.

Activity on the Ukrainian stock market has grown steadily, resulting in large measure from privatization of companies within the energy, oil and gas, chemical and heavy industry sectors. Stock exchanges and over-the-counter trading systems have emerged, though the majority of transactions is still carried out directly between companies. While this represents a good start for Ukraine's fledgling securities market, many steps remain to be taken to optimize its performance. Ukraine has only been independent for just over six years; thus, both the market and its regulation are still at an early stage of development.

The Legal Framework

The basic Ukrainian law defining the securities market, including clauses defining the procedure for issuing and circulating securities and clauses defining the legal status of traders and stock exchanges, is the law "On Securities and Stock Exchange" (1991) (the "Securities Law"). The general procedure for establishing different types of companies, including joint stock companies, and defining the procedures for operation of these companies by shareholders and management, including the issuance of shares, is determined by the laws "On Enterprises," "On Entrepreneurial Activity" and "On Business Associations" (1991).

Recently, a number of other important laws and regulations have come into force addressing in greater detail activities on the securities market. To begin with, pursuant to the amendments to the Securities Law and the law "On State Regulation of the Securities Market in Ukraine" (1996), the State Commission on Securities and the Stock Market (the "Commission") was granted significant power to develop regulations on the securities market and control the implementation and enforcement of these regulations. Among other activities, the

Commission now registers both the issuance of shares and the permits required for carrying out professional activities on the securities market.

Another significant step was the adoption of the law "On the National Depository System and Peculiarities of Electronic Circulation of Securities in Ukraine" (1997) (the "Depository System Law") which defines the depository system and its participants, and the procedure for issuing and circulating securities. Setting up a new depository system should increase investor protection as well as enhance the liquidity of the Ukrainian securities markets.

The following types of securities can be issued and traded in Ukraine under the Securities Law: shares, state and municipal bonds, bonds issued by enterprises, treasury obligations, saving certificates, promissory notes and privatization papers. Special rules apply for the circulation of shares and bonds of foreign companies in Ukraine. Such securities must be registered with the Securities Commission. Only securities that are listed on one of the authorized stock exchanges (New York, American, Tokyo, Toronto, Hong-Kong, Frankfurt or London stock exchanges) can be registered for circulation in Ukraine. All transactions with foreign securities must be carried out through stock exchanges or through trade-information systems, like the computer based PFTS. A Ukrainian company may also invest in foreign securities that are not traded in Ukraine if it obtains an individual license for the particular transaction from the National Bank of Ukraine.

Ukrainian State and municipal bonds can be owned by both domestic and foreign investors. Transactions with State bonds by non-residents can be carried out only through banks specifically authorized to do so by the National Bank of Ukraine. Investments into municipal bonds by a foreign investor must be carried out either through a permanent establishment in Ukraine or a registered professional local trader. The procedure for investing in municipal bonds by non-residents is to be determined by future regulations of the Securities Commission.

Offshore trading of Ukrainian Securities

In 1997, a procedure was established for those Ukrainian companies having an authorized capital funds exceeding Hr5 mil-

lion to have a portion of their shares and bonds traded abroad, subject to the approval of the Securities Commission. This option is not available for an initial offering of securities. The total par value of securities allocated for trading abroad is limited by the Securities Commission, and cannot exceed 25 percent of the authorized capital fund of the issuer. Interestingly, securities allocated abroad can not be traded in Ukraine for 18 months from the date of issue.

Share Registrars

Under the National Depository Law, every legal entity issuing shares must maintain either its own share registry or have its share registry kept by an independent registrar licensed to carry out such activity. If the number of shareholders exceeds a threshold amount determined by the Securities Commission (currently 500 shareholders), then the issuer must have its share registry kept by an independent registrar pursuant to a written agreement.

Taxation of Securities Transactions and Dividends

One of the key issues for participants in financial markets is the taxation of profits on transactions in securities. The general profit tax applicable to residents is 30 percent. Profits received by non-residents from interest payments, as well as from the redemption of corporate bonds or state and municipal bonds are also subject to 30 percent profit tax. Interest paid on or the profit margin (discount) realized on government treasury bills issued outside Ukraine through authorized foreign agents is exempt from tax.

Dividend payments received by domestic or foreign shareholders are subject to 30 percent profit tax, withheld by the payer when the dividend is paid. However, the payer's corporate profit tax is reduced by the amount of tax withheld on its dividends. The dividend tax, therefore, has an economic rather than a tax effect - the law effectively prevents a company from distributing its entire profit in the form of dividends.

The new tax legislation distinguishes between profit tax paid by non-residents and a repatriation tax. Dividends received by non-residents, in addition to being subject to the 30 percent profit tax, are also subject to a 15 percent repatriation tax, although this 15 percent rate usually comes down after international tax treaties signed by Ukraine have been considered. Capital gains of non-residents are also subject to this 15 percent repatriation tax, although the procedure for its payment is somewhat uncertain.

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Interestingly, current tax legislation establishes that such international tax treaties do not affect profit tax rates for non-residents, except in the case of the repatriation tax. This rule appears to contradict other laws of Ukraine, including special laws concerning the effect of international treaties, and is likely to be repealed. The Government has already announced that it intends to suspend application of this controversial provision until the issue is expressly resolved by Parliament.

Shareholder Rights

The increasing volume of transactions in shares of Ukrainian companies brings up another important issue: the protection of the rights of minority shareholders. The protections expressly provided to shareholders under current Ukrainian legislation are very limited, and include the following:

- certain key decisions can only be adopted by a 75% majority vote of the general meeting of shareholders (approval of changes to foundation documents, annual accounts, creation of subsidiaries, branches and representative offices, and liquidation of the company);
- all shareholders must be informed about the date of the general meeting of shareholders 45 days in advance;
- 10 percent of the shareholders may call an extraordinary meeting of shareholders and put questions on the agenda of any gen-

eral meeting;

- 10 percent of the shareholders may appoint an official representative to audit the registration of shareholders for a general meeting;
- shareholders are supposed to have preemptive rights to shares subsequently issued by their company.

These declared protections generally lack effective enforcement mechanisms. The remedies presently enforced under Ukrainian law for shareholders are as a practical matter not always sufficient to prevent management or shareholders from manipulating a company by lawful or unlawful means. There are many examples of claims that invitations to shareholders meeting were sent late or were not sent to all shareholders, that certain shareholders were refused admission to meetings and that stock was diluted by capital increases without giving effect to preemptive rights. Many of these possible problems can be addressed by better structuring of the foundation and internal documents of the company to give minority shareholders significant rights.

Protection that foreign shareholders take for granted - for example, protection against share dilution - must be specifically expressed in the company's foundation documents or through shareholder agreements. Although companies are not prohibited by legislation from entering into shareholder agreements (the required foundation agreement can serve as a shareholders agreement), these agreements may have ambiguous legal consequences. Because most laws addressing shareholder rights are by nature mandatory, it remains legally questionable to what extent they can be freely modified, even when such modifications improve protection mechanisms. The immediate challenge is for Ukrainian courts to adopt a more protective attitude and intervene more on the behalf of shareholders whose rights have been violated.