

About the enhancement of the accounting institutes activity regulation in the securities market

During the analyzed period the former management of FFMS without any discussion with the participants of the accounting infrastructure and their self-regulating organization by the end of the year increased for more than two times the requirements to the own capital of infrastructure institutes.

Newly specified requirements on the correlation of the licensee's own capital to the standard specified by FFMS of Russia from January 1, 2008: for registrars - 60 (since January 1, 2009 – 100) millions of rubles, for depositories – 40 millions of rubles, and for the settlement depository – 200 millions of rubles, - according to absolute values and correlation between them in no way connected with the potential risks, realized during the accounting institutes activity. PARTAD experts consider that goals of preventive protection of ownership rights and legal investor interests could be achieved without the FFMS stimulation of insurance mechanisms application in mentioned activity.

It should be mentioned that other licensing requirements preserved by the new Licensing order of professional kinds of activity in the securities market, approved by the FFMS of Russia Decree from 06.03.2007 No. 07-21/pz-n "About the approval of licensing order of professional kinds of activity in the securities market"¹ (further – the Order), arouse quite a number of questions including those about the practical reasonability of underlying principles of social and state interests protection.

According to the pt. 3 of section 2 of the minutes of the Meeting on issues of the financial market accounting system development (minutes No. 07-6-1/pr from 15.06.2007) held in PARTAD with the participation of V.D.

¹ FFMS of Russia Order from 06.03.2007 No. 07-21/pz-n "About the approval of licensing order of professional kinds of activity in the securities market"// Statutory acts bulletin of federal executive authorities. 2007. No. 23. June 4.

Milovidov, suggestions of SRO on alteration of the mentioned Order were sent to the FFMS².

Not insisting on full cancellation of the FFMS of Russia quantitative licensing requirements, PARTAD experts however offer to enhance them by addition (with partial substitution) of qualitative requirements to the accounting institutes activity.

For example, requirement of the subpoint 3.7.2 of the Order about the mandatory presence at registrar of no less than 50 contracts with issuers, whose issues had passed the state registration with the amount of securities owners more than 500 at each, had not achieved the goal of its adoption – increasing of registrar’s reliability by provision of its independence from the issuers during their consolidation – can be modified with the help of other licensing terms of qualitative and quantitative character, providing increasing registrar’s reliability together with simultaneous provision of necessary level of its technological development and scale of activity.

Supposing that passing from quantitative to qualitative licensing requirements will become more effective facility for provision of successful solution of state goals in regulation of the activity of all categories of professional market participants, it is suggested to begin their gradual implementation in the FFMS statutory acts with standards which would specify licensing requirements for the accounting institutes activity, as for the public one. It is especially actual in relation to registrars.

About licensing requirements to accounting institutes of securities market

The main of currently existing licensing requirements to registrars (presence of no less than 50 contracts with issuers with the amount of securities owners more than 500 at each) is outdated. In fact, this

² PARTAD suggestions on alterations and additions in FFMS statutory acts on revisions carrying out and professional activity licensing / PARTAD letter from 15.06.2007. No. 80-k.

requirement came into operation since 01.12.1997 (implemented by the FCSM Decree from 27.11.1997)³.

**Table
Licensing requirements to organizations carrying out register
maintenance (since 1997)⁴**

Normative document Name	Licensing requirement formulation	Validity	Comments
FCMS RF Decree under the Government of RF from 30.08.1995 No. 6 "About the temporary licensing order of the activity on maintenance of register of registered securities owners"	No licensing requirements connected with the amount of serviced issuers	30.09.1995 29.09.1996	
FCMS RF Decree under the Government of RF from 30.08.1995 No. 6 (edition from 17.09.1996) "About licensing of the activity on maintenance of register of registered securities owners"	Presence at applicant maintaining registers at a point of filing of an application: 1) no less than 25 issuer's registers with the amount of registered securities more than 500 at each, and the location of issuers and applicant should be the territory of a single constituent of Russian Federation 2) or presence of, as a rule, no less 100 ths. of accounts	30.09.1996 30.11.1997	First point didn't apply to registrars located in Moscow, Moscow region, Omsk, Rostov, Saint-Petersburgh, Leningrad region, Nizhny Novgorod, Novosibirsk, Ekaterinburg Irkutsk, Kazan, Chelyabinsk, Khabarovsk.
FCMS RF Decree under the Government of RF from 30.08.1995 No. 6 (edition from 27.11.1997) "About licensing of the activity on maintenance of register of registered securities owners"	Presence at applicant maintaining registers at a point of filing of an application on the license prolongation of no less than 25 issuer's registers with the amount of registered securities more than 500 at each, and the applicants located in Moscow and Moscow region, Saint-Petersburg and Leningrad, Nizhny Novgorod, Samara and Sverdlovsk region – no less than 50 issuers registers with the amount of registered securities owners at each issuer more than 500.	01.12.1997 02.07.1998	Registrar was dispensed from this requirement since the April 1, 1998 if there were leading registrars from the federal group in the list
FCMS RF Decree from 19.06.1998 No. 24 (edition from 13.11.2002) "About the approval of the decree about licensing of the activity on maintenance of register of registered securities owners"	Presence at applicant maintaining registers during the whole period of activity from the submission of the first application on the license prolongation of no less than 25 issuer's registers with the amount of registered securities more than 500 at each, and the applicants located in Moscow and Moscow region, Saint-Petersburg and Leningrad, Nizhny Novgorod, Samara and Sverdlovsk region – no less than 50 issuers registers with the amount of registered securities owners at each issuer more than 500.	03.07.1998 08.09.2001	
...			
FFMS RF Order from 06.03.2007 No. 07-21/pz-n (edition from 09.08.2007) "About the approval of licensing order of professional kinds of activity in the securities market"	Presence after 6 months after date of acquisition of license of no less than 50 contracts with issuers, whose securities issues had passed the state registration in accordance with the Russian Federation legislation with the amount of securities owners more than 500 at each, whose registers are maintained by the licensee;	15.06.2007 - ...	

³ FCSM of Russia Decree from 27.11.1997 No. 41 "About alterations and additions to the FCSM Decree from 17.09.1996 No. 18 "About alterations and additions to the licensing order of the activity on maintenance of register of securities owners" // FCSM of Russia bulletin. 1997. No.9. December 1.

⁴ Zamelina O. "About licensing requirements to organizations, maintaining registers" // Securities market. 2007. No.21 (348). November.

Almost ten years had passed since that time, and this requirement just insignificantly changed its formulation and moves from one document to another (see table). However in the meanwhile occurred significant changes in Russian reality and in the domestic securities market. Though, requirements outdated long ago are still applied in regulation of its fundamental component – accounting system.

Indeed, for the period of formation of the licensing system of professional securities market participants in the midst of 90-th years of the last century, presence of this requirement may be recognized as logical and reasonable. Registrars existed at that time only for 1-2, maximum 3 years, regulatory base was in embryo, and infrastructure participants themselves had no definite ideas considering requirements to their activity. The regulator also had no significant experience in the area of licensing. Because of this criterions chosen for entering and working in the market of these services, for that moment were very simple: exclusive kind of activity, independency (share of each participant – no more than 20%), own capital sufficiency, personnel qualification and presence of reasonable, real client base. It is the last requirement that was formulated as servicing of no less than 25 (and in most developed regions – 50) joint stock companies with the amount of shareholders more than 500 at each. Why more than 500 shareholders? Because for the moment an overwhelming majority of joint-stock companies was created in the period of mass privatization by turning of former state enterprises, which are characterized by a large number of personnel – future shareholders, into joint-stock companies. Servicing of a large number of such clients was considered to be a guarantee that the registrar would be stable in its activity. It is obvious that implemented by the FCSM Decree No. 41 quantitative criterion also had the goal of excluding of occasional participants from the registrars market. However, since that time significant changes occurred in the structure of joint-stock companies,

which is registrar's client base. It seems that it was significantly influenced by three factors:⁵

1. Mass purchase of stocks during redistribution of share capital.

PARTAD experts consider that influence of this factor particularly clearly demonstrates illogicality of mentioned licensing requirement. Indeed, if the number of joint-stock company shareholders reduces (for example, from 501 till 499) than it becomes not valid issuer for the registrar though it will work the same way as before. No qualitative changes occurred with the joint-stock company (moreover, occurred changes are independent from it and from the registrar), but for the registrar servicing this register, these changes become just qualitative – he may lose license because of the decrease of the amount of valid issuers, and together with it also the right for register maintenance, including the one of mentioned issuer.

It should be taken into account that the concentration of ownership rights on shares because of their purchase in the midst – end of 90-th had a mass character. Moreover, PARTAD members experience allows to state that many joint-stock companies consciously decreased the shareholders amount lower than 500 because it (in aggregate with some other actions) allowed them to evade information disclosure in the form of quarter reports and notifications about significant facts of their activity.

2. Joint-stock company liquidation during the bankruptcy process.

A large number of enterprises didn't survive in new working environment and tests of market economy. With the certain part of probability it is possible to state that the share of such organizations is larger among large-scaled joint-stock companies (an enterprise under the management of so-called "red" director, created and "adjusted" for the goals of planned economy – this is a typical example of a joint-stock company, that finished its way by a bankruptcy procedure).

⁵ Ibid.

3. Compulsory stocks redemption from their owners.

This mechanism worked since 01.01.1996 till 31.12.2001 as the consolidation with the following compulsory redemption of fractional shares, and became possible also after adoption of amendments to the federal law “About joint-stock companies”⁶. Currently this process is just initiated in many Russian joint-stock companies, but there are many reasons to suppose that firstly, the amount of those who used this opportunity will be quite significant and secondly, that the large-scaled joint-stock companies with the number of shareholders more than 500 will constitute the basic share of such societies.

The transformation of the joint-stock companies during the significant restructuring should be also mentioned. So, in the autumn 2000 the Board of directors of open-joint stock company “Sviazinvest” decided to unite 72 Russian enterprises in communication area into 7 large-scaled interregional companies. Many of these companies were joint-stock companies with the number of shareholders more than 500.

So, all mentioned above proves that during the past ten years significant changes occurred in registrar’s client base, including structure changes. The amount of large-scaled joint-stock companies (with the number of shareholders more than 500) decreased. From the other side a large number of newly created, economically effective enterprises, interested in registrar’s services and understanding the importance of its role in corporate governance process irrespectively of the number of shareholders. Besides, the significant amount of joint-stock companies with the number of shareholders more than 50, continues maintaining of the register by oneself, thus violating the law.

But, instead of competition with each other for the right of servicing of solvent clients, many registrars are forced to struggle for valid issuers. And

⁶ Federal law from 26.12.1995 No. 208 – FL “About joint-stock companies” (edition from July 27, 2006) // Russian gazette. 1995. No.248. December, 29.

as the outcome of it – complete contradiction of goals and results of licensing requirements application. Even a person – not economist understands that qualitative goods and services may be produced only in competition with other manufacturers. But the analyzed licensing requirement leads to a special kind of “competition” – for suggesting to a valid issuer of more beneficial terms of servicing – simply speaking the lower subscription fee. Of course it becomes much more difficult to improve the quality of services.

And the demand for qualitative services exists. General economic growth in the country led to increased activity in corporate relations area. The future unquestionably belongs to registrars, which already develop new products in the area of providing services to issuers and “non-professional” investors. Several perspective areas according to PARTAD experts in which registrar services are extremely necessary:

1. Information and reference servicing of joint-stock companies.

The importance of such services will only increase in the light of raising regulator requirements to the level and quality of disclosed information.

2. Corporate “turnkey” servicing, i.e. provision of a service complex as completed as possible, beginning from register maintenance, organization and holding of shareholders general meetings and ending by corporate relations audit and preparation of internal joint-stock company documents.

This service is mostly needed for companies producing goods and seeking to outsource as much number of processes as it is possible (including everything connected with corporate relationships).

3. Services connected with realization of regulations from the article XI.1 FL “About joint-stock companies”⁷ (acquisition of more than 30% of shares of an open joint-stock company).

⁷ Ibid.

Currently, practice of working in this area is just formulating, but it is obvious that correctness and propriety of redemption procedure depends a lot from the registrar.

4. Counteraction to raider captures.

There is an opinion that accomplices for such captures are often fraudulent, so-called “project” registrars. But, actually, the analysis of recommendations which professional, specialized in counteraction to hostile takeovers, consultants give to joint-stock companies shows that one of the first point of every such recommendation – transferring of register maintenance to independent registrar.

In spite of all forecasts, connected with the possibility of Central Securities Depository creation, the demand in registrar’s existence will not disappear. But it becomes more difficult for many of them to comply with licensing requirements and it is caused not by the qualitative decrease of registrar’s level, but by moral obsolescence of licensing requirements themselves.

It is obvious that registrar’s consolidation is a native process just like for any other business area. But it should be the result of competition, and it should be marketing and not artificial competition caused by the existence of administrative obstacles. Consumer, i.e. joint-stock company, inevitably will make its choice in favor of qualitative services of a reliable registrar. Eventually, this will lead to registrar’s consolidation, but caused by economical reasons, as the registrar, which is suspicious or providing sub-quality services, will lose its clients and cease to exist.

In response to arguments mentioned above it is said that cancellation of discussed requirement will make more active creation of new registrars possible. But they also appear now (about 10 for the past 3 years), and it is an open secret that the licensing barrier is frequently overcome, with the help of “technical” methods – “cloning” of valid issuers, their enticing from competitors with the help of dumping prices, and eventually their

elementary purchasing from more large-scale colleagues. I.e. existing administrative obstacle by no means is a barrier for appearance of “project” registrars. Besides, during the initial working period (6 months after the license receiving, when it is enough for the registrar to have 15 valid issuers), it is possible to realize all goals, for which the “project registrar” was created and then easily forfeit a license.

Undoubtedly, cancellation of mentioned quantitative requirement will not solve this problem, because at the first sight the market entrance will become simpler. The matter is not only about simple cancellation of one of licensing requirements, but about the revision of such requirements formulation in principle, and about that a turn from quantitative to qualitative requirements in registrar’s licensing should be made.

Speaking about registrar’s consolidation it is important to be guided by the principle of reasonable sufficiency. The bigger becomes the object the harder it becomes to govern it. In all registrars the growth of the amount of serviced clients happens because of new subsidiaries creation or development of existing. If the amount of these subsidiaries is 5-10 then the parent organization is still able to control and govern their activity. If the amount of subsidiaries exceeds optimal, then it becomes harder and harder for the head office to follow the situation in subsidiaries, to gain the execution of numerous rules and regulations of registrar’s activity. As a rule, major registrar’s subsidiary is created on the basis of smaller regional one, and the personnel of collapsed registrar transfer in a body in this subsidiary. Often, subsidiary created in this way may remain an alien body in registrar’s structure, living by its own rules, as management of registrar has no opportunity to provide the necessary attention because of its territorial remoteness. By developing this idea it is possible to suppose that the existence of such subsidiary provides excellent opportunities for different abuses. The FFMS regulatory “stimulation” for application of electronic document management at interactions of the registrar’s head

office and its subsidiaries and transfer agents could become an exit from this situation (see section 5).

PARTAD experts and members consider that licensing requirement to the accounting institutes should be changed at least in three areas:

1. Requirements to technical and technological equipment status.

Accounting system reliability to a large extent depends on its equipment status, on technologies used by it. Therefore, according to PARTAD experts it would be logical to put forward in the capacity of licensing requirements the presence of a single software for register maintenance at every registrar, electronic document management system with the usage of digital signature (further – DS) for the interaction with its subsidiaries, transfer-agents and nominees in registers, and also systems of backup and archiving of accounting data, necessary for register maintenance.

Requirement of mandatory usage of systems of EDM, backup, and archiving is applicable to depositories either, in the first place to the settlement one.

Besides, in the assessment criterions of every accounting institute activity the requirements for used placement, security systems, should be prescribed more clearly, thus also allowing to raise the reliability of information and document storage, and consequently of the institute itself.

2. Requirements to own capital sufficiency and procedure of its settlement.

Brought by the FFMS Order from April 24, 2007 No. 07-50/pz-n⁸ increasing of sufficiency standards of own capital is formally intended for decrease of professional activities risks in securities market, for increasing

⁸ FFMS of Russia Order from 24.04.2007 No. 07-50/pz-n “About the approval of sufficiency standards of own capital of professional securities market participants, as well of management companies of investment funds, unit investment funds and non-governmental pensionary funds” // Statutory acts bulletin of federal executive authorities. 2007. No. 23. June 4.

of reliability of financial market infrastructure institutes. But to make it in the best possible way it is necessary to diversify protection mechanisms, include compensation instruments, meant for covering of possible losses from the professional activity risks realization.

It seems that the existing method of own capital calculation of professional participants of securities market⁹ (further – Method), not in full facilitate to the actual decrease of professional activity risk, including such of registrar’s activity. It would be reasonable to include the *insurance covering* on the professional liability insurance contract into the list of assets, accepted for the own capital calculation in accordance with the Method. Unlike money on the settlement account or in deposit, bills, fixed assets, i.e. those assets which are currently accounted at the calculation in accordance with the Method, registrars and depositories are unable deal with the assets of insurance covering voluntarily. From the other side it is the professional liability insurance contract that guarantees protection of interest both of investors and professional market participant. Modern history of Russian financial market already knows cases of significant insurance benefit on such contracts (see section 6).

Attention given to this question by SRO tells about the increasing role of liability insurance in professional participants activity. At calculation of depositories and registrars ratings, made by INFI/PARTAD more attention is given to indexes, which actually characterize work reliability, and in particular to the risk insurance covering.

3. Requirements to the personnel qualification.

Existing licensing requirements allow to the accounting institute, which doesn’t have subsidiaries, to have in its staff only three assessed employees, two of which are – manager and controller. Though

⁹ FFMS of Russia Order from 29.09.2005 No. 05 -43/pz-n “About the approval of method of own capital of professional securities market participants calculation” // Statutory acts bulletin of federal executive authorities. 2005. No. 45. November 7.

qualification certificate issued by SRO in accordance with the FFMS of Russia requirements is a guarantee, though even minimal, of that this employee has enough qualification for working in accounting institute. It seems that these requirements may be enhanced. For example: work experience in securities market for middle managers; certain percentage of assessed employees among specialists, which have direct relation to registry maintaining activity or depository activity.