

Maxim Kalinin
General director of the registrar “Nikoil”

QUAZIMARKET OF PSEUDOSERVICES: INTERDEPOSITORY BRIDGES AND SCHEMES

Accounting institutes by definition are a connecting link between issuers and investors, a guarantee of reliability and stability of the whole financial system. But an optional application of interdepository schemes, reasonability of which is motivated by the absence of central securities depository, may later lead to violation of rights of not only issuers but either of investors.

LITTLE ABOUT DIFFERENT

History knows many examples when in pursuit of chimeras created with their own hands even persons with remarkable intelligence putted priorities of “revolutionary reasonability” above the law and common sense. Our country is, probably, the champion in these attempts, but by no means their monopolistic generator. It a pity, that we again take the risk of becoming an example of such practice. For a long time I considered it impossible for myself to debate with argumentation with apologists of conception of interdepository bridges and “bridge-like” schemes, thinking that it is an internal affair of depository community. History revealed that I was wrong.

Widely popularized now Speedy Settlement Scheme (SSS) is organized by closed joint-stock company “The ING Bank (Eurasia)” (further – ING) and Non-commercial partnership “The National depository center” (further – NDC)¹. What is regarded as of paramount importance by founders? Surprisingly, but it is not a reliability and speed of operations (hereof below). Independence from a registrar and its “excessive charge for re-registration” is main in this scheme. Let’s divide these points on two parts and analyze them separately.

Main obstacle for development of securities market infrastructure in Russia is, in my view, the fact that absolute majority of depositories (first of all – settlement depositories, in a less degree – depositories-custodians) absolutely don’t understand that their role is in connection of issuers and investors, and not in their division. Key infrastructure object – to be a bridge between investor and issuer. All speculative reminiscences appeared well after! The infrastructure can’t and has no right to forget about its main mission. Unfortunately in modern Russia this burden is carried only by registrars. Few depositories are ready, for example, to cooperate with issuers on issues of irregular (not connected with corporate actions) contacts with investors.

Besides, it appears an impression that depository clients – are their certain property, “marriageable girls”, which are closely guarded by attentive “aunty”-custodians against immodest gazes of “lady-killers”-issuers – with such puritan virtue custodians refuse to issuers in disclosure of information about their clients. Yes, formally they are right – depositories have the right to act in this way, but, if to be honest, this is an obstacle for normal interaction of a joint-stock company and its shareholder. And I am sure that none of clients is informed about such requests – depository determines himself what is good for its client and what is bad. It appears that depositories replace by themselves the final investor in its interaction with joint-stock company. I think that it is not necessary to build long logic chain to explain that goals of investor and depository are absolutely different.

Besides, I am ready to fight to the last for my point of view: goals of investor and issuer are much more similar than goals of investor and depository. And at this moment the second part of the problem appears – the question of pricing. By this argument some depositories, as it seems to them, provide the final confirmation of registrar’s incapacity as one of infrastructure elements

¹ Sidorova N. Role of custodian depository in the absence of Central securities depository // Depositarium. 2008. No. 7

(though there are “double registers”, but I wouldn’t provide arguments against them because of compassion on opponents). Well, let’s look into this system of arguments.

“Registrars became completely insolent. They take unreasonable money only for one operation in register. They are sitting without doing anything, and than – bah! - and a thousand or even tens of thousands of rubles for processing of one assignment!”

I had enough of this whining! I don’t analyze the income of custodians and I don’t analyze how much money they receive only for that their clients just store securities with them, without making any operation for weeks! And may be it would be more profitable for investors to store shares in register, in which they, at least, were not charged for pseudoservices of custody? Eventually, there are different investors – some don’t make operation with his shares during the whole year. What for to spend money? Registrars didn’t interfere in this questions (it seems in vain) first of all out of the sense of corporate solidarity, correctly thinking that the shadow, produced on the part of the market will cover it all. I am not talking that the investor, which is visible and clear to issuer, can more easily influence through him on registrar (and his pricing policy). I repeat it is not my business, let the broker take his commission, custodian – his own, registrar – his charges. It is incomprehensible why one of the participants of big and complicated process of rights of ownership accounting allows himself (by mouths of few, but significant players) to defame his partners by farfetched single-sided arguments. We kept silence. I am not sure that it was right.

We can argue for a long time about who is a weak component in the financial market infrastructure. For all these years, registrars kept noble silence, not complaining on numerous complexities in relations with nominees and correctly supposing that most part of our colleges don’t pertain to problems, which we and our clients (issuers) met because of strange accounting system imposed on us regardless of world experience.

Few know about constant imbalances between data in the register and depository accounting at the disclosure of registers on corporative matters.

Few know about depositories which lost license, but never gave information about their clients (which now “live” in register in the form of ephemeral accounts of dead nominees).

Few know about real prices, which are paid by investors for depository services, though the latter make a loud noise concerning registrar’s money-grabbing.

Few know about how hardly occurs the disclosure of nominees (and shareholder’s participation) for purposes of corporate actions. Let’s leave it for future articles. There is an urgent topic.

THE POINT IN DETAILS

So, from the end of the last year the major Russian depositories ING and NDC began to make operations through the SSS scheme. As a conceptual basis of application of the SSS scheme its authors usually provide the following reasons: there is no central securities depository which is a single settlement depository for all trading floors, and therefore schemes of assets transfer between markets are necessary, which would be alternative to more expensive and long transfers between omnibus accounts in registers. Therefore, by analogy with interdepository bridge between NDC and DCC, SSS is proposed as a temporary scheme, which, as the “bridge” NDC – DCC, in perspective, according to its authors, should give way to a more effective settlement system of central securities depository².

Indeed, created as a temporary structure bridge between DCC and NDC works for 10 years and for all these years it quite relatively corresponds with existing legislation. It’s creation in due time was justified by the necessity to increase the liquidity of the market which “lapsed into coma” after the default of 1998, and now it is assumed as a certain custom of business intercourse.

² Cherkassky B.V. SSS – the scheme which brings markets together// Exchange overview. 2008. No. 4.

Anyway, interdepository arrangement is set between ING and NDC, according to which the parties began the realization of SSS scheme on behalf of clients of mentioned organizations³, in particular, according to the arrangement NDC opened in ING an interdepository account, intended for operational custody of shares. It is said that it is made to make depositors of ING, which are not ready to assume risks of NDC as a settlement depository, to feel more confidently. On this stage of the scheme usage we, in fact, deal with the interdepository bridge between stock market of MICEX, serviced by NDC, and international market of depository receipts, presented in Russia by ING. Independently from economical reasonability of interrelation of two markets within Russian financial market infrastructure (which, apparently, exists) let's dwell on the issue of legality of the SSS scheme.

Indeed, according to the point 7.5 of the Statement about depository activity in Russian Federation, approved by the decree of FCSM of Russia from October, 16, 1997 No. 36 (further – FCSM Statement), depositories have right to make an arrangement about interdepository relations, according to which the client (depositor) of a depository is another depository. In case, when the client (depositor) of a depository is another depository, accounting and certification of securities of clients (depositors) of a depository-depositor is made on their total sum, without division on separate clients-depositors. And according to requirements of the FCSM Statement a depository, which made an interdepository arrangement with another depository, which becomes its depositor, is liable to perform functions of a nominee holder of securities of this depository and/or its clients in the register of holders of registered securities or in another depository.

At the same time it is necessary to mention that transfer of the rights of ownership on securities between the client of ING and client of NDC according to the SSS scheme doesn't imply a mandatory appeal to registrar of any depository for registration of transfer of rights of ownership on securities, and accounting of rights is made in accordance with the order of interdepository operations conducting. It is possible because, though NDC has its own nominee accounts in corresponding registers, in this case it can receive them by transfer from other ING clients as its depositor, and balances of ING account in register won't change. The reverse transfer from NDC client to another ING client is harder to perform. It is made immediately, only if there is enough amount of securities on the account of the NDC in the ING. This quantity may not be predicted beforehand, as the NDC account in the ING is used for open custody of securities of many its clients, which make differently directed operations independently from each other. If the amount of securities on the NDC account in the ING is insufficient to perform a concrete operation, than it is performed after the NDC tops up its account in the ING by transferring securities from its omnibus account in register. On its site NDC directly states that: *“Currently NDC doesn't guarantee the availability of the amount of shares on the NDC interdepository account in the ING, which are necessary to perform any client's order. The period of performance of depositor's order with the usage of the scheme may correspond to the period of performance of depositor's order with the usage of NDC and ING accounts opened in corresponding register”*⁴. And the main task of management of balances on interdepository account of the NDC in the ING is the avowal of provision of opportunity to perform depositor's orders with the ING as a place for settlements by maintenance on the interdepository account of the NDC in the ING of necessary amount of shares.

In fact from this description of the SSS scheme operation follows that operations on account of the NDC in the ING are netted, i.e. there is only periodical necessity in coverage of accumulated difference on certain amount of operations, the size of which is more than balance on the NDC account in the ING. Transfer between omnibus account of NDC and ING in registers corresponds only with the need in provision of operations balance on the account of NDC in the ING.

Let's leave alone for now that, in fact, in this case the ING acts as a settlement depository and clearing organization. Let's note that the NDC according to the description of its functions doesn't accept on itself a complete responsibility to make settlements on transactions with securities, which pass through the scheme upon its client's order. The NDC in case of insufficiency of securities on its account in the ING has a right to hold up the performance of securities transfer by the ING from the NDC account upon the order of the NDC depositor on period, which is necessary to perform transfer of corresponding securities in the register from the omnibus account of the NDC to the omnibus account of the ING.

³ <http://www.ing.ru/rus/press/releases/index.wbp?article-id=938431CC-A6DA-40FD-8F0C-3C0320061BB9>

⁴ <http://www.ing.ru/rus/press/releases/index.wbp?article-id=938431CC-A6DA-40FD-8F0C-3C0320061BB9>

Thereby, it may be concluded, that the NDC as a depositor of the ING depository according to the interdepository arrangement and as a nominee in the register of securities holders when the *SSS* is realized allows in a concrete moment of time the denial of its responsibilities as a depository for accounting of transfer of the rights of ownership on registered uncertificated securities for each holder of securities, which are accounted on its account in the ING in accordance with the order of making a receipt entry on the securities account of a purchaser in the system of depository accounting according to the article 29 of the Federal Law “About securities market”.

In this case securities holders, which are depositors of the NDC, in our opinion, may become mistaken that they have rights on securities under some interdepository relations between the NDC and the ING, allowing to account rights on securities in the future (without identification of these securities holders in the system of depository account in the moment of appeal for rights registration) after verification and mutual settlements on accounts of mentioned depositories – participants of interdepository relations. It also should be said that such interdepository operations are not provided by existing legal rules concerning depository accounting.

Besides, the ING without having the FFMS license on exercising of clearing activity, according to registered in the FFMS rules of settlement-depository activity doesn't have due legal capacity to perform mentioned type of settlements on transactions with securities. For example, on the basis of point 3 of the article 49 of the Civil Code of RF, which constitute that the right of legal person to perform activity, which requires to obtain a license, appears from the moment of obtaining such license.

As a result, the organizers of the *SSS* scheme admit a situation when persons which consider themselves as security holders according to the ING or NDC data of depository accounting, in fact won't have rights confirmed by a legal accounting system, as the accounting of their rights in some moment may not be performed neither in the register maintaining system, nor on securities accounts in depository, which is considered by holders as a nominee of their securities in the register. In fact it concerns that the activity of accounting of rights of ownership on client's securities, involved in this scheme, is supported by all its participants by performing a joint settlement-depository and/or clearing activity. It's not necessary to say that such activity is not based on existing legislation, i.e. simply speaking, is not provided by it, unlike the depository activity of each concrete depository, which requires licensing and exercising in compliance with the license.

So, even if interdepository operations of the ING and the NDC will be perfected, thus excluding possibility of mistakes in fixation of data about holders of securities, this fixation won't be depository accounting, which grants rights according to Russian legislation. Consequently, it won't have legal effect and may be admitted as non legitimate.

Any loss of data because of technological circumstances by depositories – participants of examined interdepository relations (as a result of technological failure of equipment and because of other reasons) will automatically exclude in future the probability to register investor's rights on securities in accordance with the order established by law. And the investor relying on invalid information of depositories – participants of the *SSS* scheme, will have a false certainty of having rights on securities, which are legally affirmed by mentioned depositories.

It should be mentioned that judicial authorities are still practicing recovery of penalty on the nominee's account, and only principled stand of the absolute majority of registrars, as a rule, doesn't allow exercising such actions, which contravene to basic principles of rights of ownership accounting. But in case of successful write-off of securities from the omnibus account of nominee, which belong to one of its clients, all holders of shares included in the *SSS* scheme may suffer losses.

Besides, according to the point 7.6. of the FCSM Statement the contract of interdepository relations should suppose information receipting procedure in cases provided by federal laws and other statutory acts, concerning securities holders, accounting of which is made in depository – depositor. And depository, in which the account of another depository is opened, is in charge not for correctness and authenticity of information, but only for accuracy of its transfer to third parties. The contract of interdepository relations should bind them with responsibilities of verification of data on client's (depositor's) securities, and also should determine the order and period of verification.

Also it should be kept in mind that according to the article 29 of the Federal Law “About securities market” that exercising of rights on registered uncertificated issued securities is made by issuer in relation to persons which are mentioned in the register maintaining system.

Because of it a depository as a nominee according to the article 8 of the Federal law “About securities market” is liable to provide observance of rights of security holder to receive income on securities and to participate in management of society by provision to holder of the register of the list of securities holders, for whom it is a nominee on a certain date.

At the same time, the *MIDCAP (Mutual Information Disclosure for Corporate Actions Procedure)* procedure used by SSS scheme organizers supposes that the ING and the NDC for each issuer and for each type of shares (common and preference) will estimate total amount of shares, which are stored on omnibus accounts in each other on the date of register clipping and determine which of two positions is larger. Then the party, which has more shares on its account, opened at another party, exercises disclosure of clients on difference between two positions. In other words a net position is estimated between balances on omnibus accounts of the ING and the NDC on each issuer and each type of security for the purposes of disclosure of issuer’s list on a certain date. ING clients, information about whom is provided to NDC in accordance with this procedure, is determined on the basis of their agreement on its application. Information about the rest client participating in settlements, i.e. those who didn’t agree with the *MIDCAP* procedure, will be disclosed as if their shares were stored directly on omnibus accounts of ING and NDC in the register⁵.

Thereby it becomes obvious that none of depositories – SSS scheme organizers doesn’t assume to guarantee effectiveness and accuracy of provision of depositors lists to exercise there rights on securities, also because it doesn’t have such accurate information for a concrete point of time, which is a gross violation of nominee’s responsibilities, determined by the article 8 of the Federal law “About securities market”.

From the one hand by the *MIDCAP* procedure, used by the ING and the NDC, an “artificial” accounting of rights on securities is supposed, which is not provided by existing legislation, from the other hand according to the SSS scheme organizers opinion, client’s agreement on execution of so-called *MIDCAP* procedure, for example, gives rights for the ING to determine information about which ING clients, participating in settlements with the scheme application, will be disclosed to the NDC for further provision to registrar. Thereby, on the pretext of depository client’s consent to the *MIDCAP* procedure it is supposed to violate issuer’s right to know what nominee exactly has a legal right to represent the interests of securities holder in the register and to leave the provision of this information at the discretion of depositories. And the issuer’s final liability for legality of accounting of the rights of ownership is taken out of the brackets in mentioned arrangements, thus allowing to persons, which potentially had suffered damage because of such activity, to raise a claim to issuers of securities, accounted by the SSS scheme.

As a result securities issuer’s rights are outraged. Taking judicial practice into consideration it is easy to suppose that when the weaknesses of the SSS scheme will become apparent in practice, it is the issuer who will return all loss, made by “improper accounting” of securities issued by him.

It should be also mentioned that being professional securities market participants, organizers of any interdepository schemes in compliance with point 1.10 of the Order of licensing of professional activity types on securities market, approved by the Rule of the FFMS from March 6, 2007, No. 07-21/pz-n, are liable to comply with licensing requirements and terms while they perform their professional activity.

If to speak about the satisfaction of needs of professional market participants in interconnection of Russian securities market and derivative from it market of depository receipts on Russian issuer’s securities, it could be reached without violation or circumvention of existing legislation – by changing of existing interpretation of application by a settlement depository of the Rule 17f-7 on the part of Securities and Exchange Commission (SEC) and/or by implementation of direct electronic data interchange between custodians – holders of rights on ADR and registrars.

⁵ http://www.ing.ru/media/rus/ing-in-russia/department/depository/information/SSS_clients_notice_rus.pdf