

УДК 341.96

REFORM IN THE SECURITIES CLEARING AND SETTLEMENT SYSTEM REGULATION IN UKRAINE

РЕФОРМА ПРАВОВОГО РЕГУЛЮВАННЯ СИСТЕМИ КЛІРИНГУ ТА РОЗРАХУНКІВ ЗА ЦІННИМИ ПАПЕРАМИ В УКРАЇНІ

РЕФОРМА ПРАВОВОГО РЕГУЛИРОВАНИЯ СИСТЕМЫ КЛИРИНГА И РАСЧЕТОВ ПО ЦЕННЫМ БУМАГАМ В УКРАИНЕ

Vygovskyy O. I.

Doctor of Jurisprudence, Associate Professor of Law, Department of Private International Law, Institute of International Relations at Taras Shevchenko National University of Kyiv. E-mail: alexandr.vygovskyy@gmail.com

Виговський О. І.

Доктор юридичних наук, доцент кафедри міжнародного приватного права Інституту міжнародних відносин Київського національного університету імені Тараса Шевченка.

Електронна пошта: alexandr.vygovskyy@gmail.com

Выговский А. И.

Доктор юридических наук, доцент кафедры международного частного права Института международных отношений Киевского национального университета имени Тараса Шевченко.

Электронная почта: alexandr.vygovskyy@gmail.com

Abstract. *Recent developments in the regulation of securities clearing and settlement system in Ukraine aimed at harmonization of Ukrainian securities legislation with the European and international regulatory standards are discussed in this article. Attention is focused on the key provisions of the Law of Ukraine “On Depository System of Ukraine” which has become one of the cornerstones of the legislative framework for the securities market regulation. These provisions are compared with the rules of UNIDROIT Convention on Substantive Rules for Intermediated Securities and the level of harmonization of the Ukrainian securities legislation with the international standards is evaluated. Particular attention is paid to the concepts of intermediated securities and intermediaries, the issues of transfer and exercise of the rights in securities and rights attached to securities under the specified Law are explored, as well as the insolvency of intermediaries and its effect on their relations with the securities account holders is scrutinized. Attention is also devoted to the regulation of netting in Ukraine and major innovation introduced in legislation in this respect. The outcomes of the author’s analysis are summarized and general comments are provided as to the degree of finality of harmonization process in the Ukrainian securities regulation and regulation of clearing and settlement systems.*

Key words: *intermediated securities, intermediaries, depository system, indirect holding system, netting.*

Анотація. *Розкриваються зміни у правовому регулюванні системи клірингу та розрахунків за цінними паперами в Україні, які спрямовані на гармонізацію українського законодавства про цінні папери до європейських та міжнародних регуляторних стандартів. Приділяється увага ключовим положенням Закону України «Про депозитарну систему України», що стали одним з наріжних каменів законодавчої бази регулювання ринку цінних паперів. Ці положення порівнюються з нормами Конвенції УНІДРУА щодо мате-*

ріально-правових норм відносно цінних паперів, які знаходяться у володінні посередників 2009 року, та оцінюється рівень гармонізації українського законодавства про цінні папери з міжнародними стандартами. Приділяється особлива увага концепції цінних паперів, які знаходяться у володінні посередників; досліджується питання передачі та реалізації прав на цінні папери та прав за цінними паперами відповідно до зазначеного закону, а також питання неспроможності посередників та її впливу на відносини між посередниками та власниками цінних паперів. Приділяється увага регулюванню неттінгу в Україні та основним змінам, запровадженням у законодавстві в цьому зв'язку. Підбиваються підсумки аналізу та робиться загальний висновок щодо ступеня завершеності процесу гармонізації законодавства у сфері регулювання цінних паперів та регулювання системи клірингу та розрахунків.

Ключові слова: цінні папери, які знаходяться у володінні посередників, посередники, депозитарна система, система опосередкованого володіння, неттінг.

Аннотация. Раскрываются изменения в правовом регулировании системы клиринга и расчетов по ценным бумагам в Украине, которые направлены на гармонизацию украинского законодательства о ценных бумагах с европейскими и международными регуляторными стандартами. Уделяется внимание ключевым положениям Закона Украины «О депозитарной системе Украины», которые стали одним из краеугольных камней законодательной базы регулирования рынка ценных бумаг. Эти положения сравниваются с нормами Конвенции УНИДРУА о материально-правовых нормах касательно ценных бумаг, которые находятся во владении посредников 2009 года, и оценивается уровень гармонизации украинского законодательства о ценных бумагах с международными стандартами. Уделяется особое внимание концепции ценных бумаг, которые находятся во владении посредников, исследуются вопросы передачи и реализации прав на ценные бумаги и прав по ценным бумагам в соответствии с указанным законом, а также вопрос несостоятельности посредников и ее влияния на отношения между посредниками и владельцами ценных бумаг. Уделяется внимание регулированию неттинга в Украине и основным изменениям, внесенным в законодательство в этой связи. Подводятся итоги анализа и делается общий вывод о степени завершенности процесса гармонизации законодательства в сфере регулирования ценных бумаг и регулирования системы клиринга и расчетов.

Ключевые слова: ценные бумаги, которые находятся во владении посредников, посредники, депозитарная система, система опосредованного владения, неттинг.

General statement of problem. The Law of Ukraine *On Depository System of Ukraine* (the “Law on Depository System”) [1] marked the remarkable step forward towards further harmonization of the Ukrainian securities legislation with the best international practices. This legislative act establishes the legal foundation for operation of the depository system and establishes the procedure for registration and certification of corporate securities, as well as the settlement under the corporate securities transactions in accordance with the global practices. It became effective on 11 October 2013 and replaced the outdated Law of Ukraine *On National Depository System and Specific Features of Electronic Circulation of Securities in Ukraine* [2] which became inoperative on 11 April 2014.

The Law on Depository System provided for the basic depository system infrastructure and introduced sweeping changes to other legal acts governing securities and stock market, supplementing them with more extensive provisions on clearing activities, maintenance of securities accounts, control over payment systems, as well as introducing the concept of netting into the Ukrainian legislation.

Starting from October 2013, the Ukrainian depository system has become centrally organized having the Central Securities Depository (the “CSD”) controlled by the National Bank of Ukraine (the “NBU”). The CSD is responsible for maintenance of the securities depository system and for accounting of securities. The depository infrastructure has also been supplemented with the Settlement Center for Servicing Agreements on Financial Markets (the “Settlement Center”). Its key function is to ensure smooth running of the securities settlements effected under the delivery-versus-payment principle.

More importantly, under the Law on Depository System the corporate securities (including traditional securities, such as shares and bonds) must be issued solely in the book-entry form in Ukraine. This can be viewed as the final step in the process of dematerialization of corporate securities with the previous stage launched by the Law of Ukraine *On Joint Stock Companies* [3] which provided that the shares shall exist solely in the book-entry form.

The ambitious task of bringing the Ukrainian securities legislation entirely in line with the international regulatory standards needs scrupulous assessment of the progress achieved. Such evaluation should inevitably be performed against the framework set out by the *UNIDROIT Convention on Substantive Rules for Intermediated Securities* adopted in Geneva on 9 October 2009 (the “Geneva Securities Convention”) [4].

Recent researches and publications. Unfortunately, to date the issues of harmonization of the Ukrainian securities legislation to the international standards and the legal problems associated with this process were insufficiently considered by the Ukrainian academicians. The issues of legal nature of intermediated securities and exercise of the rights attached to these securities have been scrutinized by many foreign researchers such as Ch. W. Mooney, H. Kanda, M. Ooi and others. Netting arrangements were the focus of in-depth analysis by Ph. R. Wood, O. Boger and some others.

Purposes of article. This article discusses the main novelties introduced by the Law on Depository System in their comparison with the relevant provisions contained in the Geneva Securities Convention. In particular, the paper considers the concepts of an ‘intermediary’ and ‘intermediated securities’ as the cornerstones of indirect holding system within the context of the regulatory framework established by the Law on Depository System, analyzes the issues of exercise of the rights attached to the securities under the new Law, and deals with the issues of insolvency of an intermediary under the Ukrainian legislation.

One of the major innovations introduced by the Law on Depository System into the securities legislation is the definition of netting as a part of the clearing procedure. It should be emphasized that no specific provision concerning netting has been available in Ukrainian legislation so far. Therefore, the separate part of the article shall be dedicated specifically to recognition of the netting arrangements in Ukraine prior to the enactment of the Law on Depository System and consideration of the changes brought by the current legal reform. The final section shall conclude our brief analysis.

Main research results. It is well-recognized that an efficient securities settlement system can enhance the integrity of the market [5]. The level of its efficiency can be measured, *inter alia*, by the degree of proximity to the legal framework established by the Geneva Securities Convention, and in particular, its key concepts and underlying principles. The paramount concepts which lie at the very root of the indirect holding systems are ‘intermediaries’ and ‘intermediated securities’, so the starting point of our analysis shall be consideration of whether these concepts were effectively adopted by the Law on Depository System and, if so, in which particular form.

Revealing no significant departure from the existing terminological tradition in the Ukrainian securities legislation, the new Law does not employ the term ‘intermediary’ at all. As it follows from the definition of a ‘securities account holder’, such an account can be opened by a

professional participant of the Ukrainian depository system or the NBU (see Art. 1 (1) of the Law on Depository System). The category of such professional participants embraces the CSD and depository institutions. The depository institutions refer to the legal entities established as joint-stock companies or limited liability companies having valid license for carrying out depository activity. Such activity can be conducted exclusively by the depository institutions and may not be combined with other activities, except for those expressly stipulated by the Law (see Art. 14 (1) of the Law on Depository System). Consequently, the professional participants of the Ukrainian depository system under the new Law represent a much more limited category of legal entities as compared to the broad scope of intermediaries in international practice. However, in the present article we shall use the term 'intermediary' for the reference to the Ukrainian legal entities validly licensed to open and maintain the securities accounts for the benefit of their clients.

The new Law establishes several types of the securities accounts, including the securities account for the depositor, for the depository institution, for the correspondent depository institution, for the issuer, the NBU, for the clearing establishment and the Settlement Center. The securities account for the depositor may be opened by the depository institution in the name of the securities owners, co-owners and notaries by virtue of the agreement on maintenance of the securities account. The CSD may open the securities account in the name of a depository institution by virtue of the depository agreement. Such account is maintained for holding the securities owned by the depositors of such depository institution (see Art. 5 (1) and 5 (2) of the Law on Depository System).

One of the significant drawbacks of the Law on Depository System is the absence of the concept of intermediated securities which is the cornerstone of indirect holding system. The Geneva Securities Convention consistently distinguishes between the 'securities' encompassing any shares, bonds or other financial instruments or financial assets (other than cash) which are capable of being credited to a securities account and of being acquired and disposed of, and 'intermediated securities' which mean securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account (see Art. 1 (a) and 1 (b) of the Geneva Securities Convention). By contrast, the Law on Depository System does not make such distinction. It contains no definition of the intermediated securities or any similar concept which would characterize them as the securities in book-entry form or interests completely distinct from such underlying securities. Instead, the legislator differentiates between the rights in securities (including right of ownership and other property rights determined by law) and the rights attached to securities arising out of the obligations of the issuer (including the right to participate in the general meeting of shareholders, right to obtain dividends *etc.*). As it follows from the definition contained in the Law on Depository System, not only securities, but also the rights in securities and/or rights attached to securities can be freely transferred from one securities account to another (see Art. 1 (12) of the Law on Depository System).

Such reluctance to introduce a new concept of intermediated securities into regulatory framework may be explained by a long-term academic debate in the Ukrainian private law doctrine concerning the legal nature of book-entry securities held in depository system. Heated discussion over the essence of such securities (whether they should be regarded *as res* or merely as a bundle of rights attested in such specific legal form) has not resulted in any adequate consensus so far. Thus, the legislator intentionally rejected the idea of formulation of any specific concept for those securities which are credited to and debited from the securities accounts.

Under the Law on Depository System, the rights in securities and rights attached to securities shall be acquired and terminated by making the relevant entry within the depository system

(see Art. 4 (2) of the Law on Depository System). In case of credit of the securities to the securities account the account holder shall acquire all the rights in securities and rights attached to securities held at the account. This provision implicitly corresponds with the Geneva Securities Convention which stipulates that intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account, and no further step is necessary to render the acquisition of intermediated securities effective against third parties (see Art. 11 (1) and 11 (2) of the Geneva Securities Convention). The new Law emphasizes that conclusion of the agreement on maintenance of the securities account shall not entail transfer of such rights to the depository institution (see Art. 18 (3) of the Law on Depository System). Rights in securities and rights attached to book-entry securities, as well as any encumbrances to such rights shall be evidenced by the record entry in the depositor's securities account and statement of such account (see Art. 8 (1) of the Law on Depository System).

The rights attached to the securities shall be exercised solely through the relevant depository institution. For example, a joint-stock company wishing to pay dividends to its shareholders shall transfer dividends to the special account of the CSD opened at the Settlement Center for their subsequent transfer to the accounts of the depository institutions which shall distribute them among the account holders (see Art. 30 (5) of the Law of Ukraine "On Joint Stock Companies"). It explicitly follows from this provision that such right may be adequately exercised by the account holder only against the relevant intermediary. By contrast, the Geneva Securities Convention envisages that the right to receive and exercise any rights attached to the securities, including dividends, other distributions and voting rights may be exercised against the relevant intermediary or the issuer of the securities, or both of them (see Art. 9 (2) (b) of the Geneva Securities Convention).

It is well established that even clear and undisputed rights and interests in intermediated securities are vulnerable in the absence of an effective means of enforcement and realization in an intermediary's insolvency proceeding [6, p. 78]. Issues of insolvency of an intermediary and its effect on the relations with the account holder generally remained entirely beyond the scope of the Law on Depository System. However, it contains some provisions which can be effectively applied in this respect. The Law establishes that depository assets of the depository institution (being the securities credited to the securities account maintained by such institution) may not be attached by the creditors of the depository institution (see Art. 18 (2) of the Law on Depository System). This provision correlates with the Law of Ukraine *On Restoration of the Solvency of a Debtor or its Recognition as Bankrupt*, as amended [7] (the "Bankruptcy Law"), under which the securities, funds and other property belonging to the clients¹ of an intermediary² shall not be included to the estate of such entity. These securities are subject to return to the client, unless otherwise provided for by the agreement of the administrator or liquidator with the client. During the recovery procedure the administrator may transfer these securities to another legal entity licensed as an intermediary (see Art. 88 (6), 88 (7) and 88 (9) of the Bankruptcy Law). Such approach is entirely in line with the conventional provisions stipulating that securities and intermediated securities allocated to the rights of the account holder shall not form part of the property of the intermediary available for distribution among or realization for the benefit of the creditors of the intermediary (see Art. 25 (2) of the Geneva Securities Convention). By contrast, the securities owned by the intermediary are subject to sale at the securities exchange (in

¹ For the purpose of intermediary insolvency regulation the term 'client' means a securities investor or issuer which entered into the relevant agreement with the intermediary recognized as a debtor or bankrupt (see Art. 88 (1) of the Bankruptcy Law).

² The Bankruptcy Law uses the term 'professional participant of securities market' as more conventional for the Ukrainian regulatory practice.

case of listed securities) or through a securities broker (in case of non-listed securities) (see Art. 88 (10) of the Bankruptcy Law).

The Bankruptcy Law also addresses loss sharing issue in case of insolvency of an intermediary. If the aggregate claims of the clients for returning their bearer securities having the same international identification number exceed the number of such securities held by the intermediary, they shall be returned *pro rata* to the claims of the clients. The outstanding claims shall be deemed as monetary claims and shall be satisfied within the general order of priority established by the Law (see Art. 88 (8) of the Bankruptcy Law).

Unfortunately, the Law on Depository System leaves beyond the scope of regulation the issues related to innocent acquisition of securities, priority among competing interests, scope of duties owed by the depository institutions to the account holders, availability of sufficient securities by such institutions and other issues arising out of the insolvency of a depository institution, as well as it does not contain any specific provisions in relation to collateral transactions with intermediated securities.

Another issue which should be considered in this article relates to netting. It is universally accepted that many general insolvency rules are rather hostile to netting and/or close-out in a post-insolvency context, and will recognize it under limited circumstances, if at all [8]. However, at present many jurisdictions have enacted statutes which sanction set-off and netting in relation to financial markets [9, p. 132]. In reality Ukraine does not belong to the group of 'netting-friendly' jurisdictions. Prior to enactment of the Law on Depository System, the Ukrainian legislation had no rules specifically addressing or defining netting in general or close-out netting, in particular. However, the absence of statutory provisions regarding netting in insolvency proceedings did not mean that the Ukrainian court would eagerly enforce the parties' netting arrangements. Despite that there were no laws or regulations in Ukraine expressly imposing prohibition on close-out netting or stating that it would not be enforceable within the insolvency or bankruptcy proceedings, absence of clear provisions in this regard might fully negate the advantages of any parties' arrangements to this effect.

In particular, the judicial practice reveals that the Ukrainian court may prevent the application of close-out netting in an insolvency proceeding following, for example, *the Ruling of the Supreme Court of Ukraine dated 11 April 2006 No. 4/797-7/73* [10] where it was held that the provisions of the Bankruptcy Law do not allow individual satisfaction of the claims of a particular creditor at the cost of the debtor's property within the bankruptcy proceedings, and thus, any set-off of counterclaims shall be in contravention of the applicable laws and shall prejudice the rights of other creditors having statutory priority. However, it should be noted that in another case the Supreme Court of Ukraine held that set-off or netting shall be permitted if effected before approval of the register of the creditors' claims (see *the Ruling of the Supreme Court of Ukraine dated 29 March 2005 No. 5/1436/536*, unreported).

Individual acceleration of obligations at early stages of bankruptcy proceedings (i.e. upon commencement of such proceedings, but prior to the date when the resolution on declaration of a debtor as bankrupt and institution of the liquidation procedure is passed by the Ukrainian court) shall be generally inconsistent with the applicable laws. The rules of the Bankruptcy Law explicitly stipulate that all the monetary obligations of a bankrupt shall become due, and accrual of late penalty and other sanctions shall cease since the date of passing such resolution. Any claim to the bankrupt debtor which has arisen during the bankruptcy proceedings may be filed only within the liquidation procedure (see Art. 38 (1) of the Bankruptcy Law). Commencement of the bankruptcy proceedings entails, *inter alia*, introduction of moratorium for satisfaction of the creditors' claims being effective till the date of termination of the bankruptcy proceedings.

No recovery of debts or penalties under the execution documents may be effected during the term of such moratorium. Consequently, the ability of a party to terminate the obligations by set-off or netting upon commencement of the bankruptcy proceedings in respect of the other party could in fact prove more than dubious in the light of the above provisions.

The Bankruptcy Law also provides for the ‘cherry-picking rights’ of the insolvency administrator. In certain cases a debtor’s agreement (contract) may be invalidated by the commercial court at the claim of the administrator or creditor if such an agreement has been entered into within the ‘suspect period’ constituting one year prior to the commencement of bankruptcy proceedings. The grounds for such invalidation include premature execution of the obligations by the debtor or the debtor’s refusal of its own proprietary claims (see Art. 20 (1) of the Bankruptcy Law). These options may also be seen as the legal obstacles to set-off or netting in the bankruptcy proceedings as such mechanisms might be equated to the ‘premature execution’ of the contract or ‘refusal of proprietary claims’, and contractual provisions on netting might be considered as a preference provided to the solvent party.

Furthermore, the financial market participants might face the risk of re-characterization by court of netting arrangement as set-off (which was previously the closest equivalent procedure to netting) resulting in need for the parties to comply with the statutory restrictions for set-off established by Articles 601 and 602 of *the Civil Code of Ukraine* [11]. In particular, only counterclaims (mutual obligations³) of the same kind which has already become due may be legitimately set-off upon the statement of one of the parties. Thus, the Ukrainian court may render invalid, for example, a parties’ agreement to set-off monetary claims against in-kind obligations or future claims without distinguishing set-off from netting.

Choice of law of a foreign jurisdiction with favorable attitude towards enforceability of close-out netting may prove ineffective since the Ukrainian court might consider local public policy as overriding the parties’ choice of law for the respective contract.

Introduction of the netting provision to Ukrainian legislation by the Law on Depository System is inextricably connected with the overall reform process in securities depository system regulation. The purposes of adoption of this Law do not embrace comprehensive regulation of the netting issues in every respect. Rather, the netting provisions are introduced predominantly for refinement of the clearing procedures regulation and are used mainly in this context. Suffice to say, the term ‘netting’ is mentioned only twice in the main text of the Law on Depository System.

As a matter of fact, the Law on Depository System by its clause 4 (16) of Section VI (“Final and Transitional Provisions”) amends the Law of Ukraine *On Securities and Stock Market* [12] by introducing, *inter alia*, definition of netting as “*full or partial termination of obligations under the transactions with securities and other financial instruments by means of set-off of claims or in other manner. At the moment of netting the obligations to be netted shall be deemed as due*”. Consequently, it explicitly distinguishes between netting and set-off as the latter is seen as one of the methods of netting (thus, eliminating the re-characterization risk), establishes no restrictions for netting under particular circumstances (for example, in insolvency or bankruptcy proceedings) and may be seen as a catch-all provision not only for netting under securities transactions, but also under OTC derivatives transactions (due to indication to “other financial instruments”). Equally important, the obligations to be netted shall be considered as mature by

³ In Ukrainian legal practice the obligations are considered mutual if a creditor under one obligation is a debtor under the other obligation and a debtor under the first obligation is the creditor under the other (the obligations subject to set-off are not required by law to stem from the same contractual relationship or from related contracts). If this and other requirements are duly satisfied, then the obligations under single agreements concluded within the Master Agreement may be legitimately set-off by the parties from the perspective of the Ukrainian law.

operation of law, notwithstanding their actual contract terms (i.e. even future obligations can be netted). This exhibits another significant statutory distinction between netting and set-off.

Unfortunately, the Law on Depository System has no provisions in respect of recognition and enforcement of close-out netting in accordance with the terms of the parties' contract. It does not establish the statutory mechanism of netting (e.g. procedure for estimation of a close-out value, conversion of the values into single currency, determination of net balance of the calculated values *etc.*), nor presents legal basis for the netting agreements. Even provision establishing that "*invalidity of agreement, the obligations under which were terminated by netting, shall not result in invalidity of the netting agreements and the results of netting*" included to the first draft of this Law was subsequently eliminated. Regrettably, no amendments are also expected to be introduced in the near future to the bankruptcy laws of Ukraine in relation to close-out netting and its enforceability against the insolvent party.

Conclusions. Recent developments in regulation of securities clearing and settlement system in Ukraine reveal significant progress achieved in enhancement of legislative framework for the securities market. Such progress includes improvement of Ukraine's capital market infrastructure by creation of CSD and Settlement Center, as well as enhancement of efficiency of the settlement system due to dematerialization of all corporate securities. Unfortunately, the reform process in this area cannot be regarded as complete. Comparison of the key provisions of new Law with the Geneva Securities Convention, as well as considerable gaps in regulation make it especially clear that adaptation of the Ukrainian securities legislation to the international standards and best practices remains the crucial task which has not yet been achieved. Further harmonization efforts will definitely be needed to ensure availability of the transparent and well-functioning national securities clearing and settlement system governed under the pivotal principles of the Geneva Securities Convention.

Introduction of the netting provisions to the Ukrainian legislation within the framework of the current reform process in depository system regulation definitely presents a positive move towards ensuring greater legal certainty with netting arrangements in Ukraine. Statutory distinction between netting and set-off reduces the risk of re-characterization which may arise in court proceedings. However, the current developments in this area cannot be considered as the adaptation of Ukrainian legislation to the best legal practices adopted by the developed countries in respect of netting. The scope of provisions of the Law on Depository System regarding netting is limited to mere introduction of the legal definition of netting to another legal act. Thus, one cannot confidently state that close-out netting of financial exposures would be safe enough and unconditionally enforceable in Ukraine against the insolvent party upon enactment of the Law on Depository System so as to provide for the legal certainty and comfort for international investors on the Ukrainian financial market.

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