

SECURITY AND STOCK MARKET STATE COMMISSION

RESOLUTION No. 1892

07 December 2010

RE: On the Approval of the draft Guidelines on the organization and operation of the risk management system by professional stock market participants

In line with clause 2 of article 8 of the Law of Ukraine “On the State Regulation of the Securities Market in Ukraine” and pursuant to identifying and preventing risks in the operations of professional securities market participants,

SECURITY AND STOCK MARKET STATE COMMISSION hereby

RESOLVES

- 1) Approve the draft Guidelines on the organization and operation of the risk management system by professional stock market participants (attached).
- 2) SSMSC securities market regulation methodology department (Oleksiy Tarasenko) shall send the draft Guidelines on the organization and operation of the risk management system by professional stock market participants to:

self-regulatory organizations of professional stock market participants (UAIB, UST, PARD) so as to get their proposals and suggestions hereon; and

relevant international organizations so as to obtain their expert opinion on compliance of said draft regulation with international norms.
- 3) SSMSC Administrative department (Andriy Goloshchuk) shall make this Resolution public by way of posting it on the official site of SSMSC.
- 4) SSMSC Commissioner Serhiy Biriuk shall be responsible for the implementation of this Resolution.

Dmytro Tevelev

SSMSC Chairman

Minutes of SSMSC meeting of “___” 2001 #___

APPROVED

by Resolution 1892 of the Securities and Stock
Market State Commission on 07 December 2010

Guidelines

on the organization and operation of the risk management system by professional stock market participants

I. General Provisions

1. These Guidelines have been developed in line with clause 2 of article 8 of the Law of Ukraine “On the State Regulation of the Securities Market in Ukraine” and article 27 of the Law of Ukraine “On Securities and the Stock Market” and apply to Ukraine’s professional stock market participants duly licensed by the established legal procedure to engage in a certain type of professional stock market activities.
2. Risk management is a process for a professional stock market participant to identify, assess monitor risks and control its risky positions, taking into account interactions of various categories (types) of risks. Risk management implies making decisions and taking actions to minimize, avoid, mitigate and hedge risks, as well as setting limits of the amount of risk and of taking risks. Risk management is to be undertaken within the level of the organization where the risk emerges, and also by means of the functions of independent audit and control of risk on the top levels of the company governance, - its management and supervisory boards.
3. The goal of developing a system of risk management is to come up with an economically viable structure of the impact on risks and their effect on the operations of professional stock market participants
4. The key tasks of the risk management system within a professional stock market participant are as follows:
 - Identify and classify risks;
 - Quantity and quality risk assessment;
 - Risk control; and
 - Risk management.
5. The key risks that stock market participants deal with can be broken down in several groups:

1) system risk: the risk effected by the national economy that determines to a certain extent the value of all securities and financial instruments traded on the securities market due to the securities market situation and peculiarities of the market where a professional stock market participant operates;

2) credit risk: the current or future risk of losses sustained due to negative changes in the financial situation of a professional stock market participant as a result of any party to a contract with the professional stock market participant defaulting on the terms of said contract, including a risk of counterparty fraud in the form of a counterparty (borrower or any debtor) failing to meet its/his/her obligations under a contract with a professional stock market participant;

3) market risk: the current or future risk of losses sustained as a result of unfavorable price or market value movement of securities or other financial instruments, including interest rates fluctuation;

4) interest rate risk: the current or future risk of losses sustained as a result of unfavorable changes to interest rates due to changes in the value of assets, liabilities, and financial instruments, which is multifaceted and includes changes in yield curve rates (for certain periods of time) of one or more instruments. The interest rate risk may be present in the portfolio of interest earning financial instruments into which the professional securities market participant invests capital, and in debt instruments used by the professional securities market participant to finance its operations;

5) price change risk: the risk emerging due to a mismatch of maturities of fixed income financial instruments and of changes in the interest rates of financial interests with variable income;

6) yield curve risk: the risk emerging as a result of changes in the slant and form of the yield curve;

7) base risk (spread) risk: the risk of inaccurate correlation when adjusting the funds earned and paid at the interest rates of different financial instruments;

8) options risk: the risk of losses sustained due to options imbedded in financial instruments , the value of options being dependent on interest rates change. The options value lies not in an obligation, but in the right given by the option to its owner to acquire, sell or change the cash flow from an instrument or a financial contract;

9) liquidity risk: the current or future risk of losses sustained as a result of a professional securities market participant being unable to unfavorable to meet its obligations, including off-balance liabilities, when they come due, without sustaining unaffordable losses. The liquidity risk emerges due to professional stock market participants being unable to manage unplanned losses and changes in the funding sources;

10) liquidity market risk: the current or future risk of losses sustained as a result of a professional stock market participant being unable to liquidate or close financial positions fast enough without incurring unacceptable losses (also known as "portfolio liquidity risk") or being unable to raise funds on time and at an acceptable cost to finance its operations;

11) operational risk: a potential risk for a professional stock market participant in terms of manageability, integrity, controllability and consistency, which may emerge due to a breakdown in the systems of the professional securities market participant in such areas as corporate governance, internal controls, IT or in other operational systems needed to engage in professional securities market participant

activities. Such breakdowns may cause financial losses due to an error, fraud, failure to perform work on time or to other unforeseen events, such as fire, power failure or other disasters;

12) personnel risk: a risk emerging due to lack of proper staff qualification or experience, their unlawful actions that cause more risk for the company, and other risks related to the personnel;

13) reputational risk: the current or future risk of losses as a result of a professional stock market participant being perceived as having a bad reputation or due to lack of its credibility with customers, shareholders, counterparties and other persons on whom the professional market participant depends, as well as due to governmental agencies taking action against the professional market participant in line with the legislation. This hampers the capacity of the professional stock market participant to do business with new counterparties, render new services or maintain previously established relations;

14) legal risk: the current or future risk of losses as a result of a professional stock market participant non-compliance or suspected non-compliance with laws or regulations, failure to meet the terms of contracts, and also abide by the practices and ethics specified in the legislation;

15) strategic risk: the current or future risk of losses as a result of wrong business decisions, failure to implement business decisions properly or ignoring changes in the external economic environment;

16) risk related to engaging in professional stock market activities (hereinafter referred to as professional activities risk) understood as the likelihood of events that make it impossible for a professional market participant to perform (or perform properly) its obligations related to carrying out its professional activities.

II. Risk management guidelines

1. Risk analysis is to include all products, services and processes of a professional stock market participant and envisage both the quality assessment of relevant risks and, whenever possible, appraisal of their quantifiable parameters. The management of a professional stock market participant is to be aware of the results of the risk analysis and made use of such results in their operations.

2. Every professional stock market participant is to appoint an officer vested with the risk management responsibility. Risks are to be identified and assessed by those staff members of the professional stock market participant that are independent of the personnel performing operations that create risks (risk taking personnel). Risks are also to be controlled and monitored by staff members other than risk taking personnel.

Those professional stock market participants that are active in the securities market, accounting for a significant share of securities trade volume, providing services to a great number of customers, having over UAH 10 million funds under management etc. (hereinafter referred to as 'big companies') may have a risk controlling and monitoring function separate from the function of risk identification and assessment. Other professional stock market participants may combine these functions in one risk management unit, which may, in its turn, be part of the internal audit function.

3. Big companies may want to create a risk management board (hereinafter referred to as the 'RM board'). The RM board is to act in line with a bylaw approved by the management body of a professional securities market participant. This board is to be headed by the RM Director who reports to the management body of

the professional market participant. The RM board is responsible for the development and control over the RM strategy to be approved by the management body. Other RM board members are to be heads of the other units of the professional stock market participant taking risks in the course of their operations.

One of the vitally important factors in creating the RM board is to ensure independence of the RM function. For instance, should the RM board work so that its members regularly dismiss the recommendations of the RM Director, the operations of the RM unit will certainly be inefficient. To prevent this potential problem, it is necessary to ensure independence of the RM Director. The RM board bylaw may specify different ways to ensure this independence, e.g., empower the RM Director to block a transaction involving risks that exceed the previously established limits that had been approved by the board of directors, or to demand that the RM board look into a transaction that exceeds the risk limits prior to permitting it to go ahead. With the above elements included in the RM strategy, this will facilitate reaching a consensus among the board members.

The RM board is to perform the following functions:

It recommends that the board (of directors) approve the strategy and guidelines on the risk assessment, management and reporting;

It analyzes and recommends that the board (of directors) approve the system of risk mitigation. This envisions capital allocation among different units of the professional stock market participant and the board involvement in the processes of budgeting and budget planning within the professional stock market participant;

It monitors the timeliness and accurateness of risk reporting by the risk taking units of the professional stock market participant;

It assesses the scope, direction and allocation of risks of the professional stock market participant within its portfolio;

It analyzes and confirms compliance of the RM management structure with the scope of operations of the professional stock market participant and testifies to the fact that the RM system is in line with the current technologies and methods;

It makes sure the risk taking units of the professional stock market participant analyze continually and have their strategies, assumptions and practices approved as being adequate and correct;

It creates and promotes an RM culture that demands and encourages risk managers and risk taking personnel to comply with the highest standards of ethical conduct;

It encourages staff members involved in risk management and risk taking take steps for continued education and participate in trainings.

4. The flow chart of the process of risk management by a professional stock market participant can be seen in the Appendix hereto.

III. Guidelines as regards the measures to mitigate professional operation risks

1. The creation by a professional stock market participant of a system of measures to mitigate risks related to its professional operations is to include the following stages:

identify risks related to the professional stock market participant's operations, identify the sources and causes of actual risks;

evaluate the amount of potential losses once potential risks occur;

develop and implement a set of measures to prevent the realization of the risks of its professional activities;

create instruments to offset potential losses from the professional activities' risks once they occur.

2. It is recommended that identification of risks involved in the activities of a professional stock market participant be performed taking into account the following factors:

possible default by a customer or by counterparty. The key factor is an assumption of the presence of an effective link between the actual financial performance of the customer/ counterparty, the available information about the customer/ counterparty, and the likelihood of their bankruptcy/insolvency going forward;

adverse events related to changing prices or the market value of financial instruments, including interest rates fluctuation;

inadvertent actions (mistakes, omissions, and/or negligence) by the staff of a professional market participant, including failure to perform or failure to perform their duties properly;

willful illegitimate (fraudulent) actions or failure to act by the staff of a professional market participant, actions of exterior persons, including actions using forged documents, as well as an unauthorized access to the computer networks of a professional market participant to destroy, change (distort) electronic data;

breakdowns (down time) of the hardware and software, communication and other equipment being used by the professional market participant in its operations.

3. When assessing the risks of professional activities, it is recommended that one proceed from the total amount of potential losses once risks occur, and from an average amount of potential losses per transaction.

4. The implementation of a set of measures to prevent risks occurring in professional operations is defined as development by a professional market participant of procedures that include mechanisms (ways) to mitigate said risks in professional activities, and control over their practical implementation.

5. While organizing a risk management system, a professional stock market participant may hedge professional activities risks, create reserves, become a member of mutual insurance partnerships, and perform other forms of investor losses compensation, these forms not being prohibited by the Ukrainian legislation.

Oleksiy Tarasenko, Director, SSMSC securities market regulation methodology department

FLOW CHART OF THE RISK MANAGEMENT PROCESS BY PROFESSIONAL SECURITIES MARKET PARTICIPANTS

