

## Navigating the new recording and custody system for LLC shares

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In 2022, the Parliament of Ukraine passed legislation introducing an alternative method for recording and holding shares in limited liability companies (LLCs) and additional liability companies (ALCs). This development allows LLC and ALC shareholders (participants) to transfer recording of their shares from the *State Register of Legal Entities, Private Entrepreneurs and Civic Associations* ("**State Register**") to the PJSC "National Depository of Ukraine" acting as the *Central Securities Depository* ("**CSD**"). This shift promises enhanced transparency, security and efficiency in share ownership, marking a new chapter for businesses and investors alike.

The CSD is a more sophisticated and institutionalised system compared to the State Register. However, it is also more complex, as its primary function is to serve as the depository for securities such as joint stock company (JSC) shares, stocks, corporate bonds and investment certificates. Unlike these assets, LLC shares are not classified as securities.

A key difference between the two systems is accessibility. While the State Register is generally accessible through notaries acting as its agents, only a limited number of authorised depository institutions (complying with CSD requirements) can act as intermediaries between shareholders and the CSD. This restriction aims to mitigate the risk of corporate raiding, which has often occurred through corrupt or fraudulent State Register agents. By limiting access to regulated financial institutions, such as banks and professional capital market participants, the CSD system is expected to provide greater security and reduce these risks.

This article analyses the advantages of the CSD system for Ukrainian and foreign investors and entrepreneurs, as well as the challenges associated with its practical implementation.

### Who can benefit from the new system?

The involvement of a selected depository institution, which must be a regulated financial institution, provides additional security for LLC and ALC shareholders, investors and creditors. Given that LLCs are the most common corporate entity type in Ukraine, the range of potential beneficiaries of this new system is quite broad.

As the new CSD system adds more costs vis-à-vis the traditional State Register system (migration costs in particular should be taken into account), the new system should be of express interest to companies with significant business operations and valuable assets. However, such companies and their shareholders should be prepared to go through relatively complex clearance, compliance and ultimate beneficiary owners (UBOs) disclosure procedures.

Beyond offering enhanced protection of ownership rights to LLC and ALC shareholders, the new system is also relevant for companies seeking to raise financing that is secured by assets and shares, as well as for the creditors of such companies. In this regard, the system introduces a mechanism for enforcing security over shares through an extrajudicial process. This process is based on a tripartite agreement between the shareholder (as the security provider), the security holder (such as a bank) and the CSD or depository institution.

Although pledging LLC shares is a common practice in financing Ukrainian borrowers or business groups with assets in Ukraine, the extrajudicial enforcement of such a security has historically been ineffective. The new system successfully addresses this issue by providing a practical and legally sound solution.

# Wolf Theiss

## Share accounts and agreements

The recording of shares in the depository system of Ukraine contemplates opening special accounts for share recording as well as reflecting other related information in these accounts, as regulated by *the Procedure for Maintaining the Recording System of Shares of Limited Liability Companies and Companies with Additional Liability*, which was adopted by decision no.525 ("**Procedure no.525**") of the National Securities and Stock Market Commission (the "**Commission**") on 17 May 2023, as well as respective regulations adopted by the CSD. The CSD opens share accounts for both a company (LLC/ALC) as well as for its shareholders.

A company wishing to opt for the new system will need to enter into an agreement (the "**Share Recording Agreement**") with the CSD in order to record its shares in it. In terms of the company's existing and perspective shareholders, they may opt either for agreements on servicing a shareholder's account(s) directly with CSD or an authorised depository institution (the "**Account Servicing Agreement**").

A separate share account is opened for the recording of shares of a particular company. If a person holds shares in different companies, said shares will be recorded in separate share accounts. These accounts are serviced based on a sole Account Servicing Agreement, provided that all these accounts are opened with one institution (either the CSD or an authorised depository institution).

Under Procedure no.525, the share accounts belonging to either a company or shareholder cannot be closed if there are any shares still recorded in it. At the same time, Procedure no.525 provides that the share recording in the depository system can be terminated (i) at the request of the company, acting based on the shareholder(s) decision and (ii) upon termination of the Share Recording Agreement.

Procedure no.525 provides that the Share Recording Agreement cannot be terminated if (i) the recorded shares are subject to escrow (except in the case of a company's termination due to liquidation or reorganisation) or (ii) the recorded shares are subject to pledge, in which case the agreement can be terminated only upon the consent of the security holder (except in the case of a company's termination due to the liquidation or reorganisation).

With respect to the grounds and conditions of termination of the Share Recording Agreement and the Account Servicing Agreement, Procedure no.525 does not provide specifics, leaving it to the discretion of the CSD/depository institutions. As a practical example, such grounds are provided in the CSD regulations and include (i) the failure to perform contractual obligations including to pay for the CSD's services and (ii) the CSD's decision to refuse to establish/maintain business relations (due to AML law requirements, the CSD rules).

## Steps for the transfer of share recording to the CSD

Based on the Law of Ukraine "*On Limited and Additional Liability Companies*" dated 6 February 2018, as well as Procedure no.525, the transfer to the CSD accounting system is at the discretion of the shareholders, which requires the company to complete the following steps:

1. **Shareholders decision.** As a first step in the process, the shareholders must (i) make a unanimous decision on the recording of all shares in the company's authorised capital in the CSD's recording system and (ii) supplement the company's charter (articles of association) with the relevant wording, providing for this option of share recording, if not already done.
2. **Agreement with the CSD.** The company should enter into the Share Recording Agreement by accession to the contractual terms and conditions proposed by the CSD, which are available on its website.
3. **Submission of documents.** The company is required to submit a set of documents to the CSD based on the list provided in Procedure no.525 and on CSD regulations. It is important to note that the company will be required to submit documents for the financial monitoring due diligence by the CSD, including the company's shareholding structure and disclosure of all persons indicated in the structure.

The next step, which is subject to the CSD's satisfaction with regards to the documents submitted, is for the CSD to submit an application on the state registration of transfer of share recording to the CSD system to the Ministry of Justice of Ukraine, which is the state authority responsible for maintaining the State Register.

The date of registration of this information in the State Register is the starting date for the share recording by the CSD. Once cleared, the CSD will (i) open accounts for the company and its shareholders, (ii) credit the shares to

the company's account and shareholder(s)' account(s), (iii) reflect information with respect to the shares, including registered encumbrance (using the entries from the State Register of Encumbrances over Movable Assets, the "**Encumbrances Register**"), as well as restrictive measures (sanctions) imposed based on the sanctions law, if applicable.

Shareholders' accounts in the system remain inactive, they only indicate the share, encumbrance (provided that it was registered with the Encumbrances Register) and sanctions. For shareholders to be able to conduct transactions (including share transfer and creating an encumbrance over the share) in their accounts opened with the CSD, they are required to enter into an Account Servicing Agreement with either the CSD or an authorised depository institution. For this purpose, the shareholder is also required to submit a set of documents for the financial monitoring due diligence to be carried out by the respective institution.

Finally, the CSD and authorised depository institutions are required to **notify tax authorities** about opening/closing shareholder accounts, including escrow accounts. The CSD are also required to notify the tax authorities about accepting the shares for accounting in its system and entering amendments into the system with respect to the shareholder(s)/share(s).

### **KYC checks and CRS compliance**

As mentioned above, both the company and its shareholder(s) are required to submit sufficient documentation to the CSD/authorised depository institution in order to comply with AML law requirements. The CSD/authorised depository institution must refuse to enter into the agreement/terminate existing contractual relations if it is unable to conduct identification and/or verification of the client/its representative, determine UBOs and otherwise comply with financial monitoring compliance requirements.

Furthermore, the CSD/authorised depository institution is obligated to refuse to enter into the agreement/open share accounts if the provided documents and information are inconsistent with the information about the company's shareholding structure/UBO that is recorded in the State Register. This implies a proper disclosure of the UBOs and the shareholding structure of the company/shareholder in the State Register and their accuracy as of the submission of the documents to the CSD/authorised depository institution.

Another issue in this context is the identification and verification procedure that the CSD/authorised depository institution must conduct while entering into the agreement with the company/shareholders. Specifically, the CSD/authorised depository institution must verify their client's authorised representatives (i.e. persons authorised to sign and submit instructions to the CSD/authorised depository institution). These procedures require the physical presence of the respective individuals and their personal submission of identifying documents or running a remote verification procedure subject to the internal regulations of the institutions. Obviously, this makes the process more complex and bureaucratic.

For the purposes of compliance with the Common Reporting Standard (CRS), the CSD/authorised depository institution may also request the information required to carry out due diligence of financial accounts and identify persons who are tax residents of the CRS participating jurisdictions among account holders and submit reports to the tax authorities.

### **Pledge over the shares**

It is well known that security over shares is a popular instrument within secured financing in Ukraine. However, it is also very well known that enforcement of security over shares in an LLC may be complex and problematic for a security holder. That is why banks and other creditors do not consider security over shares in an LLC as a "bullet-proof" or easily enforceable security.

Procedure no.525 provides for the conditions for extra-judicial enforcement of security over LLC/ALC shares, which exclude the involvement of the security provider (i.e. the shareholder) and/or the company. The new system will allow creditors to rely on the enforceability of an agreement providing for an extra-judicial enforcement, which must be executed by the shareholder (as a security provider), the security holder and the CSD/authorised depository institution.

Further security enforcement documents and steps will depend on (i) the chosen method of the extra-judicial enforcement and the provisions of the mentioned tripartite agreement, as well as (ii) the rules and respective procedures of the CSD/authorised depository institution.

To ensure the rights of the security holder, Procedure no.525 requires the security holder's consent for (i) the release of shares from the encumbrance (blocking) and (ii) termination of the recording of shares in the depository system. At the same time, in cases of non-payment for the services of the CSD/authorised depository institution or failure to provide AML related documents and information, the latter may suspend servicing such an account and refuse to perform instructions in relation to the share/account or even terminate/withdraw from the agreement.

Procedure no.525 does not prevent termination of the Account Servicing Agreement in cases where the existing encumbrance is reflected in such an account. Thus, if the agreement is terminated, the encumbrance over the shares will remain but the transactions with respect to these shares, including for the purposes of extra-judicial enforcement, will not be possible. In order for creditors to mitigate or avoid these risks, they should be addressed in the above-mentioned tripartite agreement.

Moreover, the enforcement of encumbrance requires prior notification of the security provider and/or debtor, as set forth in the Law of Ukraine "*On Securing Creditors' Claims and Registration of Encumbrance*" dated 18 November 2003 no.1255-IV. Whether or not the CSD/authorised depository institution will verify compliance with this requirement should be clarified in advance, specifically when transferring shares into pledge, preparing a share pledge agreement, identifying and verifying the security holder and so on.

### **Other benefits**

In addition to the transactional possibilities discussed above, the recording of shares with the CSD grants companies and their shareholders access to several new and ancillary services. These services include the convening and conducting of general meetings of the companies' shareholders in electronic form; the exchange of notices and supporting documentation between the company and its shareholders; pre-emptive rights related notifications; implementation of escrow account arrangements and payment of dividends with respect to the shares through the depository recording system.

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