# RUSSIA

## SECURITIES

### *SUMMARY*

The rapid development of Russia's securities market and associated growing pains over the last four years have been overshadowed by the devastation of Russia's financial markets in 1998. Russia's equity market deteriorated from the best performing in the world in 1997 to the worst by mid-1998. The government securities market was virtually eliminated by the government's decision on August 17 to restructure its debt maturing through the end of 1999. The float of the ruble and subsequent significant downward pressure on the exchange rate caused organized foreign exchange spot and futures trading to close.

Nevertheless, substantial progress has been made in Russia over the last four years with respect to market development, legislation and regulation. The financial sector became one of the most dynamic and market-oriented in Russia's economy. The Federal Commission for the Securities Market (FCSM), the primary regulator of securities markets, was established and began to exert its authority through licensing procedures and creating a regional network. At times, however, regulation and enforcement were outpaced by the explosive growth in market activity. Similarly, the development of the market infrastructure to support increasingly large and complex transactions lagged, acting as a drag on domestic market growth. Key issues include the need for stronger protection of shareholders' rights, an improved tax regime, and domestically-based clearing and settlement infrastructure. The low level of securities market activity caused by events in 1998 may provide an opportunity to address some of these shortcomings so that the operation of Russia's securities market will be improved once market sentiment reverses.

Foreign investors and institutions with foreign participation are active and prominent in Russia's capital markets and engage in a wide variety of activities. Foreign firms do not report any significant discriminatory treatment.

### *DESCRIPTION OF THE MARKET*

The Russian securities market started from scratch when the privatization of Russia's economy began in 1992. Growth was rapid, particularly beginning in the second half of 1996. The ruble became increasingly stable, interest rates lower, credit ratings were assigned to the Russian Federation and other entities, the London Club private debt rescheduling was concluded, and Russia was included in global investment indices. The new equity and debt markets gave rise to a variety of investment instruments at an astonishing pace. Among them were corporate securities (principally equities), federal government debt issues (GKOs, i.e., Treasury Bills, and OFZs, i.e., bonds); local government bonds, futures contracts on commodities, stocks and currencies, gold certificates; and veksels (promissory notes).

A few statistics provide a sense of dramatic growth in Russia's securities market. The over-the-counter Russian Trading System (RTS) was created in May of 1995. By the end of that year the RTS had a market capitalization of US$10 billion and averaged daily turnover of US$2.6 million (Tables I and II). By the end of September 1997, RTS market capitalization had grown over fivefold, reaching US$ 56.5 billion with daily turnover averaging nearly US$69 million. The nominal stock of federal government securities similarly increased from R73 billion (US$15.7 billion) at the end of 1995 to R385 billion (US$66 billion) at the end of 1997. Average daily turnover rose from a modest R0.8 billion in 1995 to a respectable R4.27 billion in 1997.

Adverse economic conditions in emerging markets affected Russian markets in the last quarter of 1997. Conditions progressively worsened through 1998. Local banks encountered declining liquidity and nonresidents reassessing their risks, contributed to a steady, marked decline in equity prices. On August 17, 1998, the Russian government and Central Bank of Russia (CBR) announced: (1) a mandatory rescheduling of its domestic debt (GKOs and OFZs) maturing through December 1999; (2) a floating exchange rate policy with the ruble's upper band against the US$ set at R9.5/US$; and (3) a 90-day moratorium on repayment of financial credits extended by nonresidents, on margin calls on credits supported by pledged securities, and on forward foreign exchange contracts. Further exchange rate pressures led the CBR to abandon defending the ruble, resulting in its fall to around R21/US$ in early September, rebounding to around R16/US$ by the end of that month.

Events over the last year have been nearly as dramatic as those over the previous three-year existence of Russia's securities market. The RTS equity index stood at 83 at the end of 1995, rising to 498 by the end of September 1997, dropping to 151 by the end of June 1998 and then another 100 points to 42 as of the end of September 1998. RTS market capitalization had fallen to US$28 billion by the end of June and to US$8 billion by the end of September, US$2 billion lower than at the end of 1995. The August 17 decision caused MICEX (Moscow Interbank Currency Exchange) to halt secondary trading of government securities, the nominal stock of which was R394 billion (US$64 billion) at the end of July. The precipitous decline of the ruble resulted in MICEX closing its foreign exchange futures operation and, eventually, even its spot trading. Trading in many other financial instruments (as well as most business activity in general) ground to a halt after the payments and settlements system ceased to function due to a lack of liquidity in the Russian banking system. In sum, the erosion of confidence in Russia's securities market was capped by a collapse of Russia's securities market.

Reviving the market will take time and requires measures to rebuild confidence. Until the Russian government concludes negotiations on rescheduling its debt subject to the August 17 decision the secondary market will be in limbo. Meanwhile, to conduct monetary policy, the CBR introduced a new instrument, the Central Bank bond (nicknamed "beaver" bills after their Russian acronym, OBR) on September 2, 1998. Initial auctions for the bills were unsuccessful, but the sixth auction, held September 30, attracted modest interest. One region, Tatarstan, has announced its intention to reschedule a US$100 million Eurobond issue. Other corporate and regional borrowers are currently negotiating with creditors to reschedule their obligations. There is incipient interest in trading defaulted Russian bank debt, in the expectation that a government bailout of the Russian banking sector will result in at least partial payment of these obligations.

Looking back over the last four years, organized securities trading has undergone significant transformation. In 1993, Russia had 120 stock exchanges and trader organizers regulated by the Ministry of Finance. Under the 1996 Securities law and subsequent regulations, the newly created FCSM required all exchanges to be re-licensed by the first of October 1997. Exchanges had to comply with more rigorous requirements, including minimum capital of ECU 2 million (US$2.3 million). By the end of 1997, eleven stock exchanges and organizers of trading had been licensed by the FCSM, a substantial consolidation of the market.

Securities trading in Russia is dominated by two exchanges, MICEX and the RTS, with the new Moscow Stock Exchange (MSE) aiming for retail trade. MICEX was founded in 1992 and is owned by 32 commercial banks and institutions, including the Central Bank of Russia, the Finance Ministry and the Moscow City government. The exchange boasts 500 participants from all Russia's regions. MICEX is the official venue for foreign currency trading and the exclusive exchange for trading government securities. In September 1996, MICEX launched futures contracts on GKOs and US$/ruble. In March 1997, MICEX was licensed for equity trading and by the end of the year listed nine shares and traded 18 others. By July 1998, 155 securities were traded on MICEX, including 77 equities and 78 regional bonds. Despite the decline in equity trading, the share of MICEX in total turnover increased in September 1998 to about one-third, about the same as RTS's share of the total. In part, trading on MICEX was aided by its Clearing House and National Depository Center which offered clients settlement and clearing services.

In 1995 MICEX was the primary venue for foreign exchange trading with an average daily turnover of US$108 million. Interbank deals later became the norm and transactions on MICEX declined. At the end of 1997, commercial banks faced declining liquidity, interbank foreign exchange dealing virtually vanished, and the MICEX spot market recaptured its preeminent role. However, following the sharp decline of the ruble, on August 27, 1998, traditional auction trading sessions which had been held on MICEX since 1992 were terminated. Currency trading on MICEX continued through SELT (System of Electronic Lot Trading), which was put into effect on MICEX in September 1997. By August 1998, trading volumes on SELT were practically equal to the volume of traditional auction trading. When SELT became the sole venue for foreign exchange trading on MICEX, the official exchange rate was set by the CBR on the basis of SELT quotations.

On October 6, 1998, a new foreign currency trading regime came into effect on MICEX. Two special sessions are held: (1) a morning session is limited to the CBR, importers, and exporters; and (2) an afternoon session is for banks trading for their own account, to the extent permitted by CBR regulations. The CBR introduced new regulations requiring exporters to sell 50 percent of their proceeds on MICEX. The approximate turnover of MICEX's currency trading at the special session in October 1998 was US$100-200 million per day.

The largest venue for equity trading Russia is run by the not-for-profit RTS, an off-exchange Nasdaq-like over-the-counter system. Created in May 1995, RTS grew to have more than 400 members in 30 locations. RTS improved market transparency by publishing prices and transaction volumes. As of the end of June 1998, RTS had 107 listings, including 64 common and 43 preferred shares. Despite the large number of listings, nearly two-thirds of turnover each year has been in six most actively traded shares. By September 30, the number of listings had shrunk to 87 (51 common, 36 preferred). Average daily turnover had fallen to around US$1 million, compared with US$62 million in 1997. Trading on RTS-2 of less liquid shares of smaller companies ceased completely. In response to the lack of liquidity in the market, RTS allowed non-cash barter trades.

The MSE was formed in February 1997, with the support of the City of Moscow, aimed at developing retail securities trade. More than a hundred investment houses, banks and other financial institutions paid into the MSE's charter capital. By the end of 1997, MSE listed 29 stocks, including the principal domestic listing for Gazprom shares, and four municipal issues.

Although finance and banking activity are concentrated in Moscow (94 of the top 100 investment firms), there are six licensed regional exchanges: St. Petersburg, Yekaterinburg, South Urals, Siberian, Vladivostok and Saratov. On regional exchanges, trade volumes are lower and prices higher. As many of these exchanges are not connected electronically with Moscow, the lack of information creates an opportunity for arbitrage. However, MICEX has united six other regional trading systems into one electronic trading system.

Collective investment instruments had a quick start in Russia. Voucher Investment Funds (VIF) targeted collecting vouchers from Russia's privatization of some 18,000 firms that began in 1992. VIFs eventually amassed 45 million vouchers, about 32 percent of all bearer privatization vouchers issued nationwide. Weak management, taxation, and the lack of regulatory oversight resulted in VIFs not becoming effective investment vehicles. By the end of 1997, the number of such funds had declined from 690 in mid-1994 to 350. A February 1998 Presidential Decree placed supervision of VIF's under the FCSM, raising the possibility that these funds might be converted into the more investor-friendly Unit Investment Funds (UIFs). UIFs were launched in November 1996 by Presidential Decree. By the end of 1997, there were 22 licensed UIFs. Most were open-end funds, but assets under management remain small, around US$38.5 million. Difficulties in asset valuations due to the illiquid market and uncertain value of GKOs and OFZs caused most UIFs to suspend operations after August 17. In early September the FCSM ordered UIFs with more than 10 percent of their portfolios invested in government activities to suspend operations. Most have announced their intention to resume activity after the government debt restructuring has been concluded.

A pilot program to launch an organized corporate bond market in 1997 was delayed due to the sharp rise in interest rates in the fourth quarter of that year. In 1994, 41 corporate bond issues were registered, increasing to 75 in 1995, but sliding back to 37 in 1997. Corporate issuers appear to prefer issuing promissory notes, or "veksels" to meet their cash needs. Non-governmental pension funds were permitted under a 1992 Presidential decree and have been established by some of the larger manufacturing, mining and banking institutions. A 1998 law provides a stronger legal basis and regulation of these funds.

Depositary receipts became a popular investment instrument for foreign investors and major Russian firms. The first American Depositary Receipt (ADR) for a Russian company was issued in 1994. By the end of 1997, 20 Russian companies had ADR programs. Russian companies also issued Global Depositary Receipts (GDRs) traded on European exchanges. Investors are attracted to these instruments by their liquidity and lower risk in clearing and settlement. According to some estimates, as of September 1997 approximately 40 percent of Russia's stock market free float was in the form of depositary receipts traded outside Russia.

**Market Regulation**

Market regulation, and the legal framework that underpins it, has improved significantly over the last four years, bringing order to a market that had outstripped the government's ability to effectively regulate it. While market oversight continues to improve, considerable work remains to be done, especially in increasing the enforcement powers.

Initially, the Ministry of Finance and the CBR functioned as market regulators. The Federal Commission on Securities and the Capital Market of Russia was created in 1994 and assumed regulatory powers from the Finance Ministry and the State Property Committee. The 1996 Securities law designated the FCSM as the successor organization and as supervisor of the securities market. The CBR and the Ministry of Finance retained limited supervisory roles. The CBR is responsible for registering new share issues for banks. In July 1997, the FCSM issued the CBR a three-year general license to license and supervise securities activities of banks. The Ministry of Finance is responsible for registering insurance company securities issues, T-bills, and municipal and regional bonds

The FCSM is a federal executive agency with ministerial status. The Commission consists of six members, one of whom is the Chairman, appointed by the President. In June 1997 the Commission named members of its 15-member Collegium consisting of representatives of the Commission, federal government, the legislature, and the CBR. The Commission issues licenses, approves share registrations, oversees market activities, authorizes self-regulatory organizations, and administers exams for market professionals. In 1997, the Commission established offices in 15 regions of Russia to supervise and advise regional capital markets activities. While the Commission may revoke licenses or disapprove share registrations, its enforcement powers remain limited

The 1996 Securities Law more clearly defines the activities of professional market participants (brokers, dealers, trust managers, depositories, clearing agents, registrars, trade organizers, and stock exchanges). In 1996 there were around 5,000 investment institutions operating in Russia and 500 registrars. In 1997 the FCSM adopted more stringent licensing standards and required professional market participants with old licenses to preregister by October 1997. As of June 1998 the FCSM had licensed 1,303 broker/dealers, 126 depositories, and 180 registrars.

In July 1997 the FCSM assumed responsibility for registering new share issues and reports. The Commission is to review the prospectuses for new share issues and approve or reject them within thirty days of submission. The companies are to submit a report on the results of the distribution within 15 days after the last share is issued. As a practical matter, registration often takes longer. During 1997 the FCSM registered 3,265 share issues and 2,231 reports. The headquarters of the FCSM retains the authority for registrations by Russia's 460 largest firms.

In 1997 the FCSM began active examinations of professional securities market participants. The Commission examined approximately 300 participants (e.g. registrars, brokers/dealers), 230 companies, and 16 mutual funds and referred information on 984 investment companies operating without a license to the Ministry of Internal Affairs for possible legal action.

Under regulations adopted in August 1997, the FCSM issued licenses to two self-regulatory organizations (SROs): the National Association of Stock Market Participants (NAUFOR) and the Professional Organization of Registrars, Transfer Agents, and Depositories (PARTAD). These SROs can assist the Commission in regulating and supervising broker/dealer and registrar activities by establishing rules for their members and ensuring compliance.

Volatility in the securities market that began in the last quarter of 1997 provoked the FCSM to work together with market participants to institute "circuit-breakers" to instill more orderly trading. In October the FCSM ordered trading to be suspended on the RTS when the prices changed by more than 5 percent. This limit was subsequently increased to 7.5 percent.

The Russian market has developed rapidly but still has a number of areas that require further work. Corporate governance and the protection of shareholders rights remain important issues. Investors in Russia point to the siphoning of profits from public companies to narrowly held affiliates or holding companies as one problem. Other abuses of shareholder rights include illegal share dilutions, lack of notification to shareholders of material issues, the violation of voting procedures and the inability of shareholders to obtain representation on corporate boards due to illegal actions by management.

The FCSM has limited enforcement and investigative powers. However, the FCSM has begun to exercise its authority to approve registrations and prospectuses more actively to protect shareholders. Recently, the FCSM issued a new regulation requiring issuers to publish draft prospectuses to provide shareholders an opportunity to raise their concerns on any potentially objectionable issues before the FCSM approves the new share issue. Shareholders who initiate court proceedings report more success in winning judgments, although enforcement remains a problem. In July 1997 the Russian government created a new State Commission for the Protection of Investors' Rights on the Russian Securities Market chaired by the Prime Minister and in July 1998 the government adopted a program to strengthen laws and regulations protecting investors' rights.

The taxation system also impedes capital market development in Russia. Brokers/dealers are subject to a 43 percent profits tax, capital losses cannot be offset against gains, and there is a lack of clarity of deductible expenses in the acquisition of shares, and nonresidents are subject to a 20 percent tax on the gross sales of non-government securities. VIFs' and private pension funds' earnings are subject to double taxation. These problems, combined with uneven tax administration, have encouraged much Russian market activity to remain offshore.

While market infrastructure is improving, there are still considerable difficulties in registering, clearing, and settling trades. Registering a trade can be complicated, requiring a trip to wherever the company's book is kept (often far from Moscow). Although regulations require that companies with more than 500 shareholders use an independent licensed registrar, some large companies use their own registrars, who are vulnerable to pressure from the issuing company. The consolidation of registrars in 1997 resulted in about 90 percent of the 200 licensed registrars handling more than 100,000 accounts of 10 or more share issues, helping to facilitate registration and reduce costs.

Clearing and settlement were well organized for the government debt market in MICEX, but less so for other securities activities, contributing to the preference for offshore settlement. MICEX adapted its system for debt clearance and settlement for equities when it started trading equities in early 1997. However, the rest of the equities market relied upon broker-to-broker settlement. With the nearly doubling in the volume of equities turnover in October 1997, RTS members sought a more reliable, faster system. They agreed with the Depository Clearing Company (DCC) in February 1998 to clear all RTS trades through the DCC. The project, however, has not been fully implemented. With the lull in market activity, the RTS is considering other options. The FCSM, also recognizing the utility of improving market infrastructure, is pursuing the idea of establishing a national depository system under the authority of a September 1997 Presidential Decree.

## Foreign Portfolio Investment

Foreign portfolio investment has grown exponentially, from US$100 million in 1995 to US$9.9 billion in 1996 to US$46.4 billion in 1997 (compared to direct foreign investment of US$6.2 billion). Most of this investment was directed to the government bond market, with foreigners holding approximately 30 percent of total GKOs. As of the fourth quarter of 1997, assets of 20 major foreign investment funds totaled US$2 billion, 70 percent of which was accounted for by five firms.

## *U.S. PRESENCE IN THE MARKET*

The FCSM does not keep statistics by nationality, but securities firms wholly or jointly owned by U.S. firms are active in Russia's securities market. These firms engage in a wide variety of activities, including trading and custody. They are permitted to serve as primary dealers on the government securities market and are members of NAUFOR, RTS, and MICEX. The Bank of New York was the depository for all Russian ADRs as of the end of 1997.

Although Russia's lack of adequate custody services was initially a problem, U.S. mutual funds have invested in Russia since April 1995. At that time, the Templeton Fund began to invest funds in Russia using a Russian custodian, Chase Manhattan Bank International, contingent upon the custodian's agreement to make arrangements to exercise tight and frequent supervision over registrars with which it operates. Since that time, improvement in Russia's custody infrastructure has helped expand U.S. mutual fund investment in Russia.

## *TREATMENT OF U.S. FINANCIAL INSTITUTIONS*

Investment firms with U.S. participation do not report that they are subject to any discriminatory treatment. Only resident firms can be licensed by the FCSM to conduct professional securities market activities in Russia. In the licensing process, the FCSM reserves the right to ask additional information from firms with nonresident participation. The Presidents and Chief Accountants of these firms must be resident in Russia. In the fall of 1997 the FCSM issued regulations requiring the heads of investment firms to be Russian citizens but rescinded them quickly.

Until January 1, 1998, foreign investors wishing to repatriate earnings from investments in Russian government securities were required to enter into a forward foreign exchange contract with an authorized bank which, in turn, entered into a compensatory foreign exchange contract with the CBR, a mirror of the forward contract. This restricted nonresidents' ability to quickly repatriate funds. Contract conditions and non-transparency of privatization tenders have made it difficult for foreign firms to compete or even participate. The government has been moving toward a more open, competitive system of privatization. In the summer of 1997, a consortium with significant foreign participation won a stake in a major Russian telecommunications firm in the country's largest privatization to date.

**Table I – Stock Market Performance**
1995-98
(End of Period; US$ Index; Market Capitalization in US$ billions)

| | 1995 | 1996 | 1997 | June 1998 | Sept. 1998 |
|---|---|---|---|---|---|
| RTS | | | | | |
| Index | 82.92 | 200.5 | 396.86 | 151.35 | 43.81 |
| Capitalization | 10 | 21 | 45 | 28 | 8 |
| MT | | | | | |
| Index | 63.02 | 144.3 | 302.68 | 114.79 | 29.54 |
| Capitalization | n/a | 26.62 | 67.03 | 37.86 | 9.79 |

RTS = Russian Trading System. Index used 21 shares at their closing price for the day. Since January 1, 1998, capitalization and index are calculated using all stocks traded on the RTS. Source: National Association of Stock Market Participants (NAUFOR)

MT = Moscow Times Index. Index uses 50 different shares at the daily average price. Source: Skate Newsletter

**Table II – Russian Stock Market Turnover**
1995-98
(US$ millions)

| | 1995 | 1996 | 1997 | Jan-July 1998 | August 1998 | September 1998 |
|---|---|---|---|---|---|---|
| RTS* | 217 | 3,537 | 15,659 | 7,426 | 218 | 26 |
| MICEX | – | – | 977 | 2,058 | 116 | 24 |
| MSE | – | – | 350 | 1,010 | 52 | 19 |

*RTS-1.
Source: MICEX