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CAPITAL MARKET DEVELOPMENT IN RUSSIA

I. INTRODUCTION

The securities market plays a very significant role in the modern economy. At the same time, in Russia its specific characteristics are determined by the economy in transition, and by the fact that it was developing during the period of active economic and other reforms. This has a strong impact on the functions and operating manner of the market.

The present study tries to track the history of major patterns of development of the Russian securities market in 1991-2000, as well as to make forecasts as to its future development.

Economic reform and the securities market in 1991-1999

As the result of implementation of reforms started at the end of 1991 Russia achieved material progress in shaping a market economy.

Below are some of the major macroeconomic events that determined the development of the Russian securities market:

1. (1992-1994) Large-scale massive voucher privatization and related events:
 - issuance of 147,000,000 privatization checks (vouchers) as freely transferable bearer securities, accepted by the State as payment for shares of privatized enterprises (huge educational effect, redistribution of ownership and creation of the securities market);
 - massive transformation of state-owned enterprises into joint-stock companies and issue of shares of privatized enterprises;
 - voucher privatization resulted, among other things, in appearance of over 40,000,000 retail shareholders (individuals) in Russia and in establishment of first Russian institutional investors (voucher investment funds).

2. (1993-1998) The development of the excessive, abusive practice of financing the deficit of federal and local budgets through securities issuance, which resulted in its collapse in 1998:

- issue of Government short-term debt securities-Government Short-Term Bonds (GKO) and Federal Loan Bonds (OFZs) in book-entry (paperless) form;
- issue of Internal Hard Currency Loan Bonds (OVVZ) by the Ministry of Finance in 1992, denominated in US Dollars, and State Savings Loan Bonds, denominated in Rubles in coupon bearer form.

Major investors on the government securities market were domestic commercial banks; some smaller banks used to have over 50% of their assets in government securities, they were the ones to suffer most on this market. Fast growth of the governmental debt, excessively high yield (50% and more p.a. in dollar terms), and the reliability and liquidity of federal governmental debt resulted in the flow of a major portion of domestic savings into this market, which inhibited the development of the equity market and growth in the real sector of the economy.

3. (1993-1994) Massive issuance of securities and substitute securities by new commercial institutions, including non-licensed financial companies, wide-spread appearance of financial pyramids.

Against the background of the underdevelopment of the market regulatory system in 1993-1994 over 1000 financial pyramids attracted funds from tens of millions retail investors. A major collapse of these companies in 1994-1995 resulted in significant undermining of individuals' confidence towards securities venture companies. At present, less than 5% of individuals are ready to invest in such financial instruments, and the main task of the State on the securities market in 1995-1997 became to assist citizens to recover their funds invested in venture companies.

After the collapse of these pyramids in Summer of 1994, as well as in light of the development of government securities market and sharp strengthening of regulatory regime on the market, absorption of funds by venture companies almost stopped after the beginning of 1995.

4. Non-payments crisis (1992-1998), soft budgetary policy and related issue of specific instruments—treasury notes, tax waivers and promissory notes.

The crisis of non-payments in the national economy, explained, in particular, by the difficulties of adaptation of enterprises to market discipline and weak application of bankruptcy resulted in a massive issuance of specific "securities" which are used for settlements among economic entities. After this the Ministry of Finance proceeded in 1994-1995 with a significant issuance of treasury notes used for settlements with enterprises towards which liabilities of the Federal budget existed. These notes were exchanged for tax waivers which were acceptable for payment of federal taxes.

In some cases regional authorities also made recognize the issue of promissory notes, which allowed them to avoid complicated procedure of registration of prospectuses of

municipal bond issues at the Ministry of Finance. A large issuance of promissory notes has inflationary implications and, besides, in Russian conditions resulted in a great number of scandals caused by the bearer form of these securities.

5. Loan-for-share auctions (1995-1996) resulting in the fast development of the power of oligarchs and increased instability of ownership rights, weakening of confidence towards the policy of reforms.
6. The August 1998 crisis, on one hand, seriously undermined the development of the securities market in general, but, on the other put an end to the pyramid of GKO's, the overvalued Ruble, the strong power of the banks and created conditions for the economic growth in 1999-2000.

Setting-up and growth stages (1991-1997)

The securities market in Russia began to develop in the first half of 1991, after the adoption of the famous Resolution of the Council of Ministers of the RSFSR #601 from December 25, 1990 "About Approval of the Provision on Joint Stock Companies". This **first** stage was characterized by the appearance of the first open joint-stock companies, the beginning of the trading of State bonds on exchanges, the creation of hundreds of exchanges, and the start of operation of first investment companies etc.

The result of this stage (by Spring of 1992) is the appearance of various types of securities with a wide range of maturities, issued mainly by the State and corporations. One can also state that by the end of this stage the formation of regulatory basis for the securities market was completed. The Resolution of the Council of Ministers of the RSFSR # 78 from December 28, 1991 "About Approval of Provision on issuance and circulation of securities and stock exchanges in the RSFSR" became the main document in this area for the next 5 years (except for privatized enterprises).

The main milestones of the **second** stage were the system of privatization legislation in 1992-1994 and the creation and development of organized government securities market since 1993.

The starting point was the Presidential Decree #721 from July 1st, 1992 "About Organizational Measures for Reorganization of State-Owned Enterprises, Voluntary Merger of State-Owned Enterprises into Joint Stock Companies", which had a significant impact on the development of the market in 1992-1994. Check (voucher) privatization technology became, in turn, a decisive factor for the development of securities market infrastructure.

In 1994 the Russian securities market had a strong influence over economic and even political development of the country, both positive and negative at the same time.

Thus, the sudden expansion of government short-term discount (non-coupon) bonds (GKO) in 1994 permitted a decrease to a certain extent the amount of free monetary resources, which reduced the inflation tempo. At the same time the government securities market inhibited investment activity on the corporate sector of the market and became one of the reasons of the 1998 financial crisis.

The sharp increase in the population's savings encouraged a huge number of issuers (often financial pyramids), oriented to retail citizens. At the same time the Government failed to address these financial pyramids either with alternative reliable financial instruments, or with an efficient system of control and fraud prevention.

In 1994 securities first started being used as a means of resolution of the non-payment crisis (treasury notes). These instruments became a substitute of money which stimulated inflation.

Finally, in 1994 Russia saw first large investments of foreign investors into equities of privatized enterprises. The absence of an adequate regulatory system and mechanisms for the stimulation of domestic investment in Russian corporate equities (through taxes and appropriate general macroeconomic and legal environment) up until the crisis in 1997- 1998 made the Russian equity market highly dependent upon the cyclic flows of mostly speculative portfolio investments from abroad.

Therefore, two quantitative shifts coincided in 1994: on one hand, the supply of securities increased drastically because of heavy issuance activity (securities issues by privatized enterprises, the Government and increased activity of financial "pyramids"), while on the other hand dramatic growth of demand for investment values took place (because of foreign investors, formation of a stable layer of the population with longer-term savings available for investment in securities, as well as due to inflow of funds from banks and other financial institutions into this market, cause by the drop in returns on hard currency and credit market operations).

By the time of completion of the implementation of the mass privatization model (1992-1994) the initial stage of institutional change in Russia was over. Its most important result was the formation of the corporate sector of the economy, the emergence of exchange and OTC markets, including the trading infrastructure and secondary market for shares of privatized enterprises, and the appearance of institutional investors.

These factors determined to a great extent further market dynamics. Because of such a fast market growth the needs of issuers and investors exceeded the capacity of the market infrastructure. If in 1992-1993 it was fair to say that the development of infrastructure was ahead of the market development, in 1995-1996 the situation inverted. Fast market development also raised the question of the development of a new legislative basis.

The **third** stage of securities market development (1996-1997) was characterized by the following key features: the development of the legislative basis (introduction of Joint

Stock Company Law and Securities Market Law in 1996), infrastructure development (growth of the number of professional market participants, appearance of licensed registrars and depositories, creation and development of the Russian Trading System, shaping of the self-regulation system of professional market participants), generally positive macroeconomic trends and significant potential for growth of market liquidity and capitalization, and increased market stability. At the same time poor corporate governance made Russian securities rather risky investments.

Another major difference of this stage of market development was growing international recognition, and access of various types of Russian issuers to world financial markets. Key events in this area were the entry of Russia into the International Organization of Securities Commissions (IOSCO), assignment of international credit ratings, a successful Eurobond issues, publication of IFC Global Russia Index, and the structuring of ADR/GDR programs by a number of companies, etc. At the same time the "pyramid" of GKO was growing at exorbitant speed.

The financial crisis of 1998 changed the situation dramatically.

Causes and lessons of 1998 financial crisis

The world financial crisis started in 1997 and, hit emerging markets most of all. Russia was not an exception. In 1997 Russia experienced an upturn in quotations. Russia, similarly to other emerging markets, felt the influence of global reorientation of investment institutions' strategies in 1998. At the same time the crisis on world financial markets led to a relatively high volatility of national stock indices throughout 1998.

It is important to note that both the Asian crisis and drop of world prices for primary goods were just the external cause of the financial crisis in Russia, which had its own specific traits. The catastrophic downfall of the Russian stock market in 1998 cannot be explained solely by unfavorable world financial conditions. The latter only aggravated internal negative trends, that arose in the Russian economy. These internal factors (GKO market, overvalued Ruble rate, poor regulation and supervision of the banking sector) became detrimental to the development of the situation in 1998.

The situation on the domestic debt market was the mirror image of what was happening in the Russian equity market. The specific feature of the domestic debt market were its short-term nature and a significant share of non-residents as investors. The domestic debt was represented by short-term (mainly less than 1 year) securities. As a result, the monthly amount required only for redemption of previously issued bonds (without taking into account coupon payments on 2-3 years OFZs) reached the level of 10-15 % of monthly GDP. Large participation of foreign investors in financing of the federal budget deficit increased the dependence of the Russian economy on the conditions of world financial markets. At the same time the corporate equity market from 1995-1998 was totally dependent on the government securities market in both volumes and dynamics.

The collapse of the GKO pyramid became, however, the collapse of the Russian equity market, but this time it occurred because of a global downfall of the national investment image of Russia after the default on domestic debt. Indirectly, the market was also affected by the indecisiveness of the Russian Government and the Central Bank regarding Ruble devaluation: investors "incorporated" devaluation risks into the price of government securities, which, through growth of yields, resulted in the further fall of equity quotations.

Of course, such a significant downfall of stock quotations and market liquidity during the period from Autumn of 1997 until Autumn of 1998 was connected to a **range of factors:**

- because of the financial crisis the danger of overall economic recession increased sharply, followed by a corresponding decrease in profitability of Russian enterprises and a deterioration of their financial condition;
- default on government debt securities, justly regarded by domestic and foreign investors as a judicial nihilism, undermined seriously the confidence towards securities of Russian Issuers and led to a "freezing" of large amounts of investors' assets;
- sharp decrease in liquidity of shares of first-tier issuers and complete illiquidity of second and third tier shares on the Russian equity market also resulted in a "freezing" of investors' assets, which led to a sudden decrease of market demand;
- banking crisis, related not solely to losses on financial markets, but to the abolishment of the primary source of revenues - GKO-OFZ market led to aggravation of non-payments, which had direct impact on securities market participants;
- the difficult financial situation of almost all Russian brokers and the crisis of commercial banks paralyzed the securities settlements system and led to a respective increase in system risks, etc.

As the result, a drop in quotations and liquidity of Russian shares, provoked by the crisis, directly affected **investment perspectives:**

- Russian companies were no longer able to attract funds through securities issuance on domestic and foreign markets;
- the State was unable borrow or sell blocks of shares of Russian issuers to financial investors;
- market evaluations of Russian companies decreased significantly, which made it impossible to sell strategic blocks of shares to foreign investors;
- direct investment funds, which, according to assessments, were planning in August 1998 to invest about 1 billion dollars in shares of Russian issuers, temporarily lost interest in investing in Russian projects.

The financial crisis of 1998 became a serious challenge for **professional market participants**. Market participants, holding assets in government securities, incurred

significant losses, which affected the overall market intermediaries business. While before July 1st, 1998 the number of professional market participants (brokerage, dealing, fiduciary securities management) and their capital was increasing, since August the situation has completely changed. The strongest decrease took place in purely brokerage services, which is related to the termination of the "vacuum cleaner" era of the market's functioning (when smaller regional brokers were buying out shares for Moscow brokers, who, in turn, were selling them further to non-residents). At the same time in 1998 dealer market for foreign investors also experienced a crisis, whereas traditional exchanges turned out to be the most viable in crisis conditions.

The subsequent period from September of 1998 through the first half of 1999 can be characterized as post-crisis stagnation. Despite the fact that already in Autumn of 1998 some segments of the Russian financial market were reanimated, a lot of key issues remained unresolved until mid 1999 (uncertainty regarding debt principle and interest, the GKO restructuring scheme, a clear program of regulation and sanitation of the banking sector in crisis conditions, overall uncertainty with respect to Russian economic development prospects). All of this deprived active economic entities of any clear short-term markers and led to stagnation in the market.

The financial crisis clearly revealed serious **impediments of the domestic securities market:**

- the orientation of market participants to speculative revenues and lack of interest in long-term investments;
- very low level of presence of domestic investors on the market (both retail and institutional);
- minimal interest of investors in transparency of the market (including, because of continued struggle for control, in enterprises);
- weak protection of investors' rights and a poor corporate governance culture;
- poor coordination of efforts of the State regulatory authorities on the securities market and persistent conflict of interests within the respective regulatory authorities, for instance, inside the central bank;
- preservation of significant gaps and contradictions in the regulatory basis of the securities market.

Post-crisis growth (1999-2000)

The period of 1999 to early 2000 gives certain grounds for optimism with regards to the development prospects of the Russian securities market. Some positive assessments, such as the one in the Report of the UN European Commission, are mostly based on the revitalization of the Russian industry after Ruble devaluation and the rise of world oil and gas prices, which resulted in an increase of tax revenues of the budget and exporters' revenues. Such positive dynamics were witnessed in the majority of industries, including chronically depressive ones (electrical manufacturing industry, consumer goods, agricultural

products processing, etc.). The UN Economic Commission believes that the year 2000 was the most favorable for the economic development in Eastern Europe over the past 10 years.

The post-crisis growth continuing in Russia in 1998-1999 (GDP: 3.2%; industrial production: 8.1%), a relative stability of the macroeconomic situation (at least, contrarily to some forecasts, avoidance of hyperinflation) and positive political developments on the edge of 1999-2000 had a positive impact on the Russian securities market. According to the majority of agencies and most influential financial media, the Russian securities market in 1999 was among the three most actively growing markets in the world. The price of Russian debt grew in 1999 to 60-70% of the face value. The market capitalization of "blue chips" grew by 185% in one year. RTS-Interfax Index became the second in the world by growth tempo (after Turkey). In January 2000 investors started to show interest in second-tier companies, which is a sign of started reorientation from purely speculative short-term investments to a longer-term strategy.

In 1999, for the first time since the financial crisis, a number of Russia's largest companies stated their intention to issue depositary receipts ("Sibneft", RAO "UES of Russia"). Another indicative fact is that most Russian corporate borrowers on the Eurobond market tried to fulfill their current obligations in a timely manner. 1999 was also characterized by the return of interest towards Russian corporate bonds. Some of the largest companies issued debt in 1999 and others plan to do it in 2000.

With all these developments in the background, the gradual increase of Russia's international credit rating looks likely, which will influence directly the ability of the Government and corporations to attract capital in international financial markets. Agreements reached in February, 2000 between the Russian government and the London Club of Creditors support these optimistic views in the mid term. However, problems still remain. External indicators of this are seen through ratings assigned to Russia with respect to the forecasts of financial markets and corporate development, even with all the positive assessments.

The "Economic Freedom Index", historically published by the American Legacy Foundation, estimates the investment climate in 161 countries. Russia occupies 121st place, being classified as "a mostly dependent country" (almost all Eastern European countries and CIS countries are classified under the same category, though with a better score). This reflects a deterioration of the situation. Ownership rights and obstacles for free movement of capital play an important role in the calculation of the index. The score for 2000 was influenced, in part, by the introduction of restrictions on the share of foreign investors in the equity capital of RAO "UES of Russia" (25%), Gazprom (20%), aerospace companies (25%), limitations applied to foreign insurance companies, legislative and court aspects of protection of ownership rights (including independent settlement of commercial disputes), taxation, corruption, etc.

The following trends will most likely be for the securities market in the short term:

- reduction of the number, consolidation mergers, and an increase in competition among professional market participants;
- post-crisis redistribution of ownership in financial groups and corporations, which will result in many violations of shareholders rights;
- appearance of financial instruments new to the Russian market, caused by the attempts of the real sector enterprises to find alternative sources of capital (corporate bonds, warehouse certificates, and mortgage securities);
- gradual development of new collective investment mechanisms (closed real estate unit investment funds etc.);
- sharp struggle for improvement of the quality of corporate governance.

II. RUSSIAN PRIVATIZATION MODEL—KEY FACTOR OF CREATION OF RUSSIAN CORPORATE GOVERNANCE AND SECURITIES MARKET MODELS

It was the Russian model of privatization (“the biggest sell-off of state property in the 20th century”) practiced from 1992–1994 that determined the basic characteristics of the structure of corporate ownership and governance in Russia (“loan-for-share” auctions in 1995-1996 did not change the overall direction of development, although they somewhat strengthened positions of oligarchs), and it also outlined the major directions for their development: three-fifths of Russian open joint-stock companies in operation today appeared as a result of privatization, and they account for four-fifths of all industrial production. *This in turn predetermined to a great extent the nature and specific characteristics of the development of the Russian corporate securities market.*

The principal features of the Russian model of privatization can be summarized as follows:

- mass corporatization in the course of privatization (more than 30,000 open joint-stock companies were created in Russia; and there are more of these companies in Russia than in the rest of the countries of Eastern and Central Europe and the CIS combined);
- Significant special advantages for insider employees and managers, and their widespread participation in privatization (at the very onset of the privatization process 50–60 percent of shares were transferred to insiders for vouchers (or sold for cash));
- a large sale (or free distribution) of shares in privatized enterprises for vouchers, which were issued to all citizens for a symbolic charge;
- the freely transferable nature of the vouchers and their free circulation on the market, which made it possible for processes involving the concentration of ownership to begin considerably sooner than the actual sale of shares.

- (Approximately 25–30 percent of citizens sold the vouchers they received, and one-third of the vouchers sold went into the hands of foreigners);
- the sale of shares under certificate-based privatization both directly and through intermediaries—certificate investment funds. (Some 25 million citizens became shareholders in 450 such funds.) The certificate investment funds were the first collective investment institution in post-communist Russia;
 - the open nature of joint-stock companies created in the course of privatization, which allowed the processes of redistribution of ownership through the free sale of shares to begin.

The specific initial structure of corporate ownership that appeared was the result of the implementation of this type of privatization model.

On average, in 1994 insiders accounted for 60–65 percent of shares held in privatized enterprises, outside shareholders accounted for 18–22 percent, and the state's ownership was as high as 17 percent.

In connection with the state's hold on large blocks of shares in so-called strategic enterprises, and by virtue of the size of these enterprises (this situation is typical of other countries as well, such as Hungary, the Czech Republic, Poland, and others), the structure of corporate ownership and, accordingly, the subsequent trajectory of the development of corporate governance, differed sharply. This was the case across enterprises in the petroleum and gas industry, the electric power industry, and telecommunications, where the state's stake was usually around 38–51 percent, and the insiders' stake was 20–30 percent. This compared with the majority of enterprises in the light industry, the food industry, and the production of building materials, in which the state's stake was nonexistent or was in the 10–15 percent range. Insiders played a dominant role.

Continuing participation by the state in the capital of many Russian enterprises is one of the main reasons for the inefficiency of their economic operations and is the source of a number of Russian political and new corporate scandals. Therefore, the privatization of these blocks is important not just in eliminating the budget deficit, but also in improving the efficiency of the Russian economy. Relevant privatization plans involving the quick sale of minority (up to 25 percent) blocks of state-held shares in thousands of privatized enterprises have been announced several times already by the Russian government, but they have not been carried out.

Generally speaking, the substantial dominance of insiders at the initial stage of post-privatization development is the most important feature of corporate ownership and governance in Russia.

This dominance by insiders and the inevitable problems and conflicts arising from this situation, which are related to the violation of shareholders' rights, are also characteristic

of other post-communist countries. For example, it is occurring in Lithuania, Mongolia, Armenia, Georgia, Slovenia, Croatia, and Macedonia.

Certificate-based privatization in Russia resulted in a major dispersion of owners, as in other countries (in July 1994 there were 40 million small shareholders in Russia, now this number is reduced). Russia experienced the same thing as the Czech Republic, for example, when immediately after the mass privatization was completed, the process of concentrating ownership in the “struggle for control” began at these enterprises. As in many other countries in Eastern and Central Europe, the managers of the enterprises played, and are continuing to play, a major role in this process.

For a number of objective reasons, such as excessive advantages offered to insider employees, utilization of the institution of investment intermediaries—investment funds—did not undergo the same sort of vigorous development in Russia as it did in the Czech Republic. For example, where the funds hold 60 percent of the shares in Czech enterprises and they are the real owners of the Czech industry. Investment funds in Russia hold approximately 10 percent of the shares in Russian enterprises and they usually fall into the outsider shareholder minority. Accordingly, they could potentially play a positive role as champion of the rights of the minority.

At the same time, managers of Russian investment funds are infringing on the rights of small shareholders, which is also the case with managers of Czech funds; the problem of “dormant shareholders” of investment funds is even more pressing for Russia, and up until 1998 the regulation of these funds was too lax.

During the course of large-scale privatization in Russia and the majority of other countries with transition economies, there were not any market quotations or reference points for the purchase of shares (as was the case with privatization in the 1980s in Western countries, such as Great Britain under Margaret Thatcher). Shares of enterprises being privatized appeared on the market for the first time during 1992–1994, and in the majority of cases their acquisition was a matter of random selection, as in a lottery. As a result, the structure of investment funds’ assets also ended up being fairly “mixed.” Now, as the market has undergone further development, quotations of many stocks have appeared and consequently, there is also an opportunity to obtain a market valuation of their assets, based on real quotations of enterprises’ stocks, and on this basis to perform an “inventory of the funds’ portfolios.” Consequently, the market for privatization funds’ stocks that are “dormant” are now going to “wake up.” This will create new stimuli and incentives for funds to act as shareholders of enterprises and as players in the stock market.

The structure of stock ownership that took shape after the completion of mass privatization at a number of enterprises is changing fairly rapidly. Specifically, from 1994 through the present the following changes have occurred:

- there has been a substantial reduction in the proportion of employee-shareholders (at the same time, employee-shareholders play a minor role in management—most of them delegate their votes to the administration);
- there has been an increase in the role of the administration (management);
- there has been an increase in the role of large outsider shareholders;
- there has been a decrease in the role of the state.

The “struggle for control” at Russian joint-stock companies now is not only not easing, but on the contrary, it is heating up, in particular in connection with the fact that a 50/50 balance of forces between insiders and outsiders has developed at many enterprises!

According to data from the Leontyev Center in St. Petersburg, by 1997 the struggle for control had already come to an end at more than 25–30 percent of Russian joint-stock companies, and as paradoxical as it may seem, in approximately two out of three cases this struggle ended with a victory by the outsiders! (According to other data sources, the number of such enterprises is even higher.) But at those enterprises where the bulk of ownership has ended up in someone’s hands, the “struggle for control” usually does not come to an end, and the primary distribution of ownership stage is quickly replaced by the secondary and tertiary redistribution stages. (As early as 1995 the first few “hostile takeover” attempts were made: the Red October Confectionery Factory in Moscow, and the Pulp and Paper Production Complex in Karelia, among others). This struggle still continues.

The majority of foreign investors and members of the general public usually shudder when they read articles by Western correspondents from Moscow about the fierce wars within and around Russian corporations. Various methods are employed in this campaign to redistribute ownership (“dilution” of blocks of shares through new issues, bankruptcy, reorganization of companies, manipulation of registers, creation of parallel boards of directors, and procedural points with regard to arranging shareholders’ meetings are employed very frequently). Things have even reached the point of the armed (!) takeover of enterprises: for example, directors, who have been removed from the office prematurely for one reason or another, take over enterprises without authorization, relying frequently on the support of local authorities and members of the labor collective, and often utilizing specialized armed units.

Indeed, let’s take a look at just the most recent corporate conflicts during 1999–2000:

- the confrontation between “Sidanko” OAO [Open Joint-Stock Company] and “TNK” OAO;
- the forcible replacement of the manager of “Transneft” OAO;
- the attempt at de-privatization of the Lomonosov Porcelain Factory;

- the conflict surrounding violation of the rights of minority shareholders of subsidiary enterprises of YUKOS NK [Oil Company] OAO;
- clashes between owners and employees, who took over the Vyborg Pulp and Paper Production Complex;
- the armed takeover of the Kachkanar Mining and Concentrating Complex (with two separate sets of managers);
- two separate sets of managers at the Orsk-Khalilovo Metallurgical Complex;
- the conflict surrounding the conversion of “Surgutneftegaz” to a single stock;
- the attempted armed takeover of “Moskhimfarmpreparat”.

It is likely that the recent aggravation of the situation is tied in part to people’s desire to create for themselves a more favorable springboard for the next stage in the campaign to redistribute ownership. This process also took place previously, and it is continuing to this day. The result of all this: *the negative image of corporate governance “Russian-style” that has emerged in this environment, and the negative impact on quotations of Russian equities.*

Methods employed by both sides in the “struggle for control” include:

- buying up shares from employees and small outside shareholders;
- putting together alliances with “friendly shareholders,” for example, representatives of the state or certificate investment funds;
- obtaining shares during the course of privatization (directly, through one’s own firms, and also at the expense of funds of the joint-stock company itself, which are used by managers);
- restricting access to the register or manipulation of the register (used by managers).

The continuing “struggle for control” to a certain degree:

- results in numerous violations of shareholders’ rights (especially on the part of managers);
- creates disincentives for the disclosure of information about enterprises (for example, because managers have no interest in disseminating information about their joint-stock company, which they want to buy themselves and buy at a lower price);
- leads to the domination of the country’s over-the-counter market, since it is not profitable for brokers to disclose prices and the volume of transactions to their clients;
- creates a situation in which enterprises do not have sufficient interest in new stock issues, out of fear of losing control of the enterprise (although there are, clearly, other obstacles to new stock issues, such as competition with monetary privatization and placement of government securities);
- is a factor hindering the effort to transfer the management of registers to independent registrars.

The phenomenon of growth for “one-way” temporary liquidity of enterprises’ stocks also arises in the “struggle for control” (a phenomenon with which we are familiar from the Czech experience).

The absence in Russia of a fully realized, functioning system for the transformation of savings of individual citizens and legal entities into investments is key evidence of the transitional nature of the current Russian model of corporate governance. This system is still in the embryonic stage: neither banks nor various types of investment funds have been able to attract the public’s savings. The bulk of savings are held in the form of cash (most often in U.S. dollars). The total amount of the public’s savings is in excess of US\$30 billion. And the nature of this model depends on what is going to become the principal means for the transformation of domestic savings into investments—banks or nonbank structures (investment funds, mutual funds, and so on).

Furthermore, in connection with heavy dependence of the Russian securities market on foreign investments, the predominance in the future of one type of foreign investment or another (strategic or portfolio), with their different approaches to the securities market as a mechanism of external corporate control, will have a significant influence on the development of the Russian model of corporate governance.

In any case, however, the creation of a system for the transformation of savings into investments will require a major effort to restore the public’s trust in investment intermediaries (banks and collective investments) after the widespread scandals involving pyramid schemes from 1994–1995 (more than 1,000 pyramid schemes were created during those years and some 30 million people fell victim to them) and people’s losses at banks stemming from the crisis of August 1998.

Restoring the public trust is a complex and long-term task which can be achieved only with a serious tightening of government control over the securities market and a targeted public information and promotional campaign.

At the present time, neither banks, investment funds, nor foreign investors of any kind are significant sources for financing the development of enterprises, i.e., the real sector.

As the economic growth stage gets under way, the situation is changing. The acceleration of this process is primarily attributed to:

- 1) a decline in the profitability and scale of government borrowing on the government securities market (which for a long period of time diverted monetary resources, particularly bank resources, from investments in the real sector);
- 2) development of the Russian legal base, for example, the creation of the institution of securing credits provided to the real sector on the basis of: privatization of land

and real property and development of a mortgage lending system, and also strengthening of the legal position of creditors;

- 3) introduction of legislative and enforceable liability for violation of shareholders' (creditors') rights, which will increase the level of interest in investing in enterprises;
- 4) the success (or failure) of efforts to increase the openness of enterprises to investors (disclosure of information, accounting reform).

III. THE ROLE OF THE LEGAL SYSTEM IN THE DEVELOPMENT OF THE CORPORATE GOVERNANCE AND THE SECURITIES MARKET (1991-1999)

The delay of legal reform during 1991-1998 not only had a material impact on the character of the securities market developed during these years, but allowed for a relatively easy creation of the so-called "financial pyramids". It also put a serious imprint on the future development of the market (e. g. the same "financial pyramids collapse syndrome").

The development of the Russian securities market from 1991-1995 went in *absence of Federal laws determining the legislative basis for the securities market*: the Joint Stock Company Law, the Securities Market Law, and the Law on Investment Funds. In these circumstances the development of the legal basis for the securities market was composed of:

- Presidential Decrees;
- Resolutions of the Government;
- Ministerial regulations.

It should be noted that market participants were forced to use outdated, Soviet-time Civil and Penal Codes and other laws.

Similarly there was no united regulatory authority in charge of the securities market. Until the beginning of 1995, the regulation and licensing of market participants was performed by the Central Bank (all securities operations of banks), the Ministry of Finance (all non-banking institutions, except for voucher investment funds and registrars) and the State Property Committee (voucher funds and registrars). The Commission for Securities and Exchanges, established in 1992 by the President of Russia, existed from 1992-1994 only as an inter-ministerial consultative agency.

1995-1996

By the beginning of 1996 active joint efforts of the President, the Government and the Federal Assembly allowed for a *qualitative change of the situation*: Parts 1 and 2 of the Civil

Code were adopted and enforced, as well as the Joint Stock Company Law and the Securities Market Law. In November 1994, the Presidential Decree created the Federal Commission for Securities (FCSM) as a united authority of State regulation of all types of professional activities on the securities market. Its powers were set forth in the Securities Market Law (April, 1996) and Joint Stock Company Law (December, 1995), as well as a number of Presidential decrees regarding the development of the securities markets.

1996-1999

Based on earlier decisions, it was possible to make significant progress in market regulation due to the active role of the FCSM, which adopted over 100 regulations for all aspects of market functioning, carried out re-licensing of professional market participants (having cleaned the market from "dead" and doubtful companies), prepared materials for initiation of criminal proceedings against over 800 "financial pyramids builders", introduced more rigorous requirements to the registration of securities issues and disclosure of information by issuers, and strengthened enforcement (struggle against oligarchs from 1998-1999).

The improvement of the legislative basis was rather slow from 1996-2000, except for the adoption of the Law "About Protection of Rights and Legitimate Interests of Investors" in Spring 1999. Many important issues, connected with the adoption of amendments to the Criminal Procedural Code and Civil Procedural Code, Joint Stock Company Law and Law on Investment Funds, remained unresolved. In particular, two programs, connected with the Investors Rights Protection, adopted by the Government in 1996 and 1998, which were not implemented.

But it is important to keep an objective assessment of currently existing legislation on securities market and joint-stock companies in Russia:

It contains a number of important measures to protect shareholders' rights. (See Table 2)

Russia is characterized by very weak enforcement of existing legislation on the protection of shareholders' rights.

Concentration of ownership has become widespread in world practice through adaptation to failings in the enforcement of legislation (particularly in Napoleonic Code countries with their weak protection of investors' rights); as "anti-director rights" are introduced more vigorously, the quality of accounting improves, and the legislation is enforced, such concentration of ownership may decline. Considering the relatively weak adherence to the legislation in Russia, one may assume that the concentration of ownership in Russia will continue, or more precisely, the campaign for the redistribution of ownership will continue, which creates room for violations of shareholders rights.

The problems of corporate governance risks, which are a key factor for the development of corporate equity market, are pressing ones for most of the countries of the world.

If we compare Russia with other emerging markets, we will see that the myth about the uniqueness of the “horrors” of corporate governance in Russia, surprising as it may seem, is nothing more than a myth. Investors are encountering these same problems in Indonesia, Korea, Brazil, Mexico, Argentina, Turkey, the Czech Republic, and India (see Table 1).

Table 1. Overview of Major Risks of Corporate Governance in Russia

Risks	Probability of risk	Uniqueness (characteristic only of Russia)	Other markets with similar risks
Disclosure of information	++	Yes	--
Share dilution	+++	No	Korea
Asset stripping/ transfer pricing	+++	No	Indonesia, Malaysia, Korea, Mexico
Bankruptcy	+	No	India
Restriction on ownership of stocks and disposition of voting rights	+/-	No	Korea, Mexico, Thailand
Reorganization (mergers and takeovers)	++	No	Indonesia, Malaysia, Korea

Source: Brunswick Warburg

The myth, which it is time to dispel, is the opinion held by some investors that Russia has no laws regulating the corporate governance sphere. It would be a good idea to take a more detailed look at the legal base of Russian corporate governance and compare it to the situation in other countries. The G-7 countries (Canada, the United States, Great Britain, Italy, France, Germany, and Japan) and 15 of the largest emerging markets were chosen for this comparison:

- 4 countries from Latin America: Argentina, Brazil, Mexico, Chile;
- 2 countries from Europe: Greece, Portugal;
- 8 countries from Asia: South Korea, the Philippines, Indonesia, Malaysia, Taiwan, Thailand, India, Turkey;
- 1 country from Africa: South Africa.

The table below was compiled on the basis of research conducted by Rafael La Porta, Florencio Lopez de Salines, A. Schleifer, and R. D. Vishny, “Law and Finance” (see Table 2, as well as Appendix 2).

Table 2

(1)	(2)	(3)	(4)	(5)	(6)
No.	Shareholders' rights	Positive (+) or negative (-) impact on investors' rights	G-7 countries	15 largest emerging markets	Russia
1.	One share – one vote	(+)	No	in 4 of 15 - Malaysia - Greece - Chile - South Korea	Yes
2.	Voting by mail using ballots	(+)	in 4 of 7 except: - Germany - Japan - Italy	in 2 of 15 - Argentina - South Korea	Yes
3.	No blocking of stocks before a shareholders' meeting	(+)	in 4 of 7 except: - France - Germany - Italy	in 9 of 15 except: - Greece - Argentina - Mexico - Taiwan	Yes
4.	Cumulative voting	(+)	in 1 of 7 - USA	in 4 of 15 - Thailand - Argentina - Philippines - Taiwan	Yes
5.	Right of a minority of shareholders to overturn management decisions	(+)	in 5 of 7 except: - Italy - France	in 9 of 15 except: - South Korea - Indonesia - Turkey - Mexico - Greece - Portugal	No
6.	Right of a minority of shareholders to demand the buy-back of stocks at a fair price in the event of major transactions, reorganization, or a change in the charter of a joint-	(+)	in 5 of 7 except: - Italy - France	in 9 of 15 except: - South Korea - Indonesia - Turkey - Mexico - Greece - Portugal	Yes

(1)	(2)	(3)	(4)	(5)	(6)
	stock company				
7.	Percentage of stocks needed to convene a special shareholders' meeting (%)	the fewer the better	1 – USA 3 – Japan 5 – Canada, Germany 10 – Great Britain, France 20 – Italy	1 – Chile 3 – Taiwan 5 – South Africa, Greece, Argentina, Brazil, Portugal, South Korea 10 – India, Malaysia, Indonesia, Turkey Philippines 20 – Thailand 33 – Mexico	10%
8.	Percentage of stocks needed to convene a special shareholders' meeting (%) [sic]	the fewer the better	1 – USA 3 – Japan 5 – Canada, Germany 10 – Great Britain, France 20 – Italy	1 – Chile 3 – Taiwan 5 – South Africa, Greece, Argentina, Brazil, Portugal, South Korea 10 – India, Malaysia, Indonesia, Turkey Philippines 20 – Thailand 33 – Mexico	10%
9.	Mandatory dividends	compensation mechanisms in continental law countries (+ for continental law countries)	No	<u>in 5 of 15</u> Chile – 30% Greece – 35% Brazil – 50% Philippines – 50% Portugal – 50%	No

The legislation in force in Russia, as one can see from the above, has already incorporated a number of important measures to protect shareholders' rights (for all practical purposes, the only thing missing is mandatory dividends and the right of a minority of shareholders to overturn management decisions).

The main reason for Russia's problems, however, is poor enforcement of the legislation. Russia is lagging seriously behind other transition economies in this regard, including a number of CIS countries.

The main conclusions regarding the influence of the legal system on the development of the Russian securities market:

1. The main problem – a weak enforcement system (including poor execution of laws on the regional level, arbitration decisions of courts, etc.);
2. The legislation is in place, but is often contradictory, there are specific gaps;
3. Poor supervision of the market by the "fourth power" - mass media.

The most typical violations of shareholders' rights include: violation of a shareholder's right to participate in a general shareholders' meeting, dilution (watering) of capital, violation of shareholders' rights in the course of reorganizations and consolidation of companies (especially in the process of converting to a single stock), violation of information disclosure requirements, asset stripping and transfer of assets to "friendly" companies, transfer pricing, conclusion of "sweetheart" deals in violation of the established procedure, and fraudulent bankruptcies with the subsequent buy-up of assets being sold.

Problem	Degree of protection	Method of protection	What needs to be done
Dilution of shareholders' stocks through stock issues	Insufficient	Law on Protection of the Rights and Legal Interests of Investors, Standards of Russian Federal Securities Commission	Amend the Law "On Joint-Stock Companies" by establishing new, clearly defined rules and conditions for the adoption of decisions to increase authorized capital. Introduce mandatory preferential rights for shareholders. Establish regulation of the procedure for issuing bonds convertible to stocks.
Violation of shareholders' rights in the process of reorganization of companies	Weak	Law "On Joint-Stock Companies"	Amend the Law "On Joint-Stock Companies" by introducing a requirement that the structure of ownership must be preserved in the event of a takeover, and a requirement that an independent appraiser be brought in. Improve information disclosure.
Violation of information disclosure requirements	Insufficient	Law "On Joint-Stock Companies," Law "On Protection of the Rights and Legal Interests of Investors"; Law "On the Securities Market," Russian Federal Securities Commission Standards	Improve legislation on information disclosure; introduce international accounting standards; impose criminal liability for failure to disclose information, ensure better enforcement.
Asset stripping ("Asset sell-off")	Insufficient	Law "On Joint-Stock Companies," Criminal Code (Articles 165, 201, 204)	Reform of labor legislation (simplification of the procedure for dismissal of general directors); improve financial reporting forms; impose stricter requirements on the procedure for effecting major transactions and stakeholder transactions, ensure better enforcement.
Transfer pricing	Insufficient	Law "On Joint-Stock Companies," Criminal Code (Articles 165, 201, 204)	Improve tax legislation; improve financial reporting forms, ensure better enforcement.

Let's take a closer look at some of these examples:

Shareholders' rights are violated most often in the placement of securities. As a result of which, a new issue is already becoming synonymous with a violation of shareholders' rights.

An example of this can be seen in the well-known conflicts of recent years at a number of oil companies: “Yukos” (transfer of funds from subsidiaries, “dilution” of shares held by minority shareholders), “Sidanko” (an attempt to issue and place convertible bonds at a below-market price for placement with affiliated parties), “Sibneft” (transfer of assets to a holding company and discrimination against small shareholders of subsidiaries in the conversion to a single stock). *It must be noted that the “share dilution” was not successful in a significant number of cases. In 1998 alone the Russian Federal Securities Commission refused state registration of stock issues in 2,600 cases, and some “oligarchs” even felt the impact (see Table 2).*

Table 2. Law Enforcement Activity by the Russian Federal Securities Commission (1998–1999)

January 1998	Refusal to register securities issue of “SIDANKO” OAO
May 1998	Russian Federal Securities Commission announced its disagreement with the Law limiting foreign ownership of stocks in United Energy Systems Republican Joint-Stock Co.
June 1998	Suspension of stock issue of “Krasnyy Kotelshchik” [Red Boilermaker] Thermal Boiler Plant OAO
September 1998	Refusal to register stock issue of “Sibneft” OAO
November 1998	Refusal to register stock issue of Vyksa Metallurgical Complex OAO
December 1998	Suspension of stock issue of “Dalmoreprodukt” [Far East Seafood Products] Holding Company
December 1998	Suspension of stock issue of NOSTA OAO
March 1999	Announcement of investigation of the special general shareholders’ meetings of subsidiaries of “YUKOS” oil company: “Tomskneft” joint-stock co., “Samaraneftegaz” joint-stock co., “Yuganskneftegaz” joint-stock co.
December 1999	Refusal to perform state registration of stock issue of “Tomskneft” joint-stock co.

It has already been mentioned a number of times that in spite of the crisis conditions in 1998–1999, there was no significant decline in stock-issuing activity by joint-stock companies. This can be explained by the fact that the mechanism involving the placement of securities is employed not as a means of attracting needed investments, but as an instrument in the struggle for control of a company through the “dilution” of shares held by undesirable shareholders (primarily small and mid-sized shareholders who hold a so-called “blocking” parcel of shares).

The Boards of directors, taking advantage of the opportunity afforded to them by the Law to adopt decisions to increase authorized capital, often placed shares through a closed subscription to affiliated persons at what were clearly below-market prices, frequently without even letting shareholders know.

The conditions of the placement were based on the “bottleneck” principle—the idea was to make it impossible or extremely difficult for shareholders to acquire stocks. For example, the placement of stocks of a large issuer occurred on one day and a shareholder had to appear in person to conclude the transaction.

Violations of shareholders’ rights involving the reorganization of joint-stock companies also became widespread. The purpose of reorganization was to allow a “controlling” shareholder to convert a profitable business into new companies. The financial problems of the “old” company were inherited by its remaining shareholders. Or the other way around, certain shareholders were forced out and into new companies with an unfavorable financial status.

Focussing on preventing such violations, the Russian Federal Securities Commission included a number of provisions in its regulatory acts aimed at protecting shareholders’ rights in the process of issuing securities. These provisions include a requirement that a decision to place stocks through a closed subscription may be adopted only by a general shareholders’ meeting of the given joint-stock company. This provision was subsequently written into the Federal Law “On Protection of the Rights and Legal Interests of Investors in the Securities Market.”

There is no let-up in the struggle for information disclosure. For example, information about remuneration paid to members of management bodies of Russian joint-stock companies is a separate page in the story of domestic corporate governance. It is self-evident that shareholders have the right to know how much management of the company costs, and where and how their money is being spent. To this end, proceeding from world practice, *the Russian Federal Securities Commission has established a requirement regarding disclosure of this information in securities issue prospectuses and quarterly reports of issuers. It is interesting that this requirement has turned out to be one of those most criticized by a majority of issuers and by some of the so-called professional participants in the securities market.*

There has been some clear progress in the information disclosure sphere. First of all, the Russian Federal Securities Commission, pursuant to the requirements of the Law “On the Securities Market,” has adopted in 1997-1999 a number of regulatory acts which identify in specific terms the nature of the information that is to be included in the quarterly reports of issuers and information about important facts concerning their financial and economic operations, and which also establish the procedure for its disclosure. In addition, requirements have been established for the disclosure of information provided by issuers in the course of a securities issue.

In all fairness, it must be mentioned that the Russian legislation on information disclosure, which was drafted under difficult conditions, is far from ideal, but does allow the investor today to obtain basic information about a company’s management.

Second, with the publication of the Law “On Protection of the Rights and Legal Interests of Investors in the Securities Market,” the Russian Federal Securities Commission obtained the authority to impose penalties for violations in the area of information disclosure. This same law established a ban on public trading of securities of issuers who do not disclose information in the amount and following the procedure established by the legislation.

Thus, as a result of actions that have been taken, *the year 1999 can be considered a turning point in the development of the information disclosure system. The number of quarterly reports of issuers available on the Russian Federal Securities Commission information disclosure server grew from 71 documents in January 1999 to more than 7,000 in January 2000, that is, it increased by a factor of more than 100.*

IV. New opportunities for the development of the securities market after Presidential elections of 2000

When the 2000' Presidential race was over in Russia, the country literally stepped into a new stage of its development. This is explained, to a great extent, by the depletion of post-communist transformation tasks per say, and, consequently, termination of the revolutionary changes era in the society, characterized by implacable political struggle and resulting in a weakness of governmental authority. Russia became a country with a market economy and a Democratic Constitution.

There are new objectives on the agenda: reform of the State (to increase its efficiency), development of democracy and capitalism on the proper basis through evolution reforms.

The peculiarity of the political situation, besides the change of the set of objectives, is in the extreme importance of the appearance of a new, young, healthy, energetic leader, not yet bound by any obligations with older but still powerful and new financial groups. Therefore, there is a potential for implementation of a long-term conscientious policy and in principal reject from "buddy capitalism". The main basis for *political stability* is in place, which is critical for the securities market.

There are a number of political problems that the President of the Russian Federation and the government face. The solution is important for reform in general and for the securities market in particular. These include the danger of de-privatization (re-privatization and nationalization); the problem is that nationalization has prevailed in Russia for a long time, in different forms:

- at the level of general ideology and political struggle (the brightest example would be the adoption of the Federal Law from May 7, 1998 about RAO "UES of Russia");
- the review of privatization transactions with investment conditions;

- the return of blocks of shares to State ownership for debt write-offs;
- the creation of new (including State-owned) holdings;
- the activity of regional authorities to establish control over budget-forming enterprises;
- the use of de-privatization by managers as a tool for corporate struggle (famous scandal around the Lomonosov porcelain plant).

A positive solution would be to decrease the period of limitation for review of privatization transactions and the application of other measures aimed at the protection of rights of the investors—good-faith purchasers in case of nationalization. But the main problem, the solution of which is something the development of the securities market depends upon among other things, is the *reform of the State*.

Problems and perspectives of capital market development

The main mid-term conditions of capital market development in Russia are:

1. *Macroeconomic and structural reforms*, primarily:
 - tax reform
 - reduction of macroeconomic risks and improved efficiency of sovereign debt management;
 - introduction of international accounting standards;
 - banking system reform;
 - development of the system of registration of real estate ownership titles and civil circulation thereof;
 - development of insurance industry;
 - pension reform and development of private pension funds.
2. Dramatic improvement of corporate governance quality, through:
 - more rigid regulation of issuers' behavior;
 - increased activity of investors themselves for protection of their rights;
 - strengthening information disclosure requirements.
3. Acceleration of legal reform, especially the enforcement component, including improvement of the court system.
4. Within the securities market itself:
 - increase of the market infrastructure efficiency, including the establishment of the Central Depository;
 - creation of preconditions for the development of collective investment vehicles, including closed-end UIFs investing in real estate;

- introduction of new financial instruments to the market (warehouse certificates, mortgage securities) and the creation of conditions for the development of existing instruments (corporate bonds);
- development of the system of insurance (guarantee) of investors' risks;
- improvement of the compliance quality with the rules on the securities market.

Speaking of some of these issues in greater detail, the following can be noted:

Tax reform

It is necessary to widely use economic methods to stimulate the development of the Russian securities market. The tax policy should be built around the following principles:

- unification of tax rates and taxation principles with respect to financial and securities market instruments and professional market participants;
- inclusion of negative differences resulting from fall of quotations on purchased securities into the expenses amounts for taxation purposes;
- removal of tax benefits on separate types of securities;
- relief of all forms of collective investments from double taxation;
- relief from double taxation of non-residents, investors and financial institutions acting as intermediaries on the Russian market in case there is an Agreement of the elimination of double taxation between respective countries;
- refusal to introduce any type of taxes or duties on securities turnover;
- simplification of the system of calculation of income tax on individuals, generating income on the securities market (including using the Moscow experience);
- resolution of the problem of taxation regarding custody and management of assets of financial companies for the purpose of payment of compensation to persons which incurred losses on the financial and equity markets due to illegitimate actions;
- to develop and adopt in priority order legal acts to create tax conditions stimulating investment by enterprises through the securities market. In particular, in order to stimulate securities issuance for the purpose of the development of production, it is worth examining the possibility to abolish the tax on securities issues of domestic enterprises.

Accounting

In 1997-1998 there were some attempts in Russia to reform the accounting system. But the accounting reform in Russia is carried out in a rather strange manner: part of the newly adopted Russian accounting rules do not comply with the international accounting standards. Therefore the reform acclaimed by MinFin is nothing more than wasting of funds:

the problem can be fully resolved by total compliance with the international accounting standards.

Lowering macroeconomic risks and sovereign debt management

An important prerequisite for the development of the securities market and investment activity is a low inflation rate, as well as predictability of price behavior in the economy. Therefore an important goal is to apply a policy aimed at steady reduction of the inflation rate and inflation expectations. Without serious efforts aimed at resolving the problem of sovereign debt, and without strict limitations of the formation of the sovereign debt, it is not feasible to improve the image of Russia among investors. The delay granted to the Russian government has to be used efficiently to restructure existing obligations, and not to create new ones.

The main result of the work of Governments of E. Primakov, C. Stepashin and V. Putin was the achievement of a budgetary balance. For the first time in the last 10 years the budget was executed with primary surplus. The importance of this achievement is comparable with the achievement of a market balance under E. Gaidar (due to liberalization of prices). The major components of macroeconomic stability were finally created through tough monetary policies and a balanced budget. This macroeconomic result partially explains the fast stabilization of major financial indicators and the improvement of the situation in the real sector of the economy.

Although macroeconomic indicators deteriorated after the crisis, the previously achieved financial stabilization was not disrupted. The relative stability of the Ruble was achieved. There is a stable positive current account balance. The payment balance was also improved significantly. The industrial growth is observed, which was to a great extent allowed by a long period of stability of natural monopolist prices and the fuel and energy industries. A more sound policy of floating the ruble rate was started, which helped to overcome the ruble overvaluation.

A very strong destabilizing factor, related to possible insolvency of the State, is the large amount of **sovereign debt**. The amount of debt is incomparable with the sources of its repayment. The timing of debt service payments is highly unfavorable. At present, the amount of sovereign debt is equal to US\$150 billion, which is approximately 90% of GDP.

The state of the sovereign debt determines the low credit rating of Russia and high interest rates, therefore, without resolving the problem of the debt, it is impossible to count on a significant capital inflow with acceptable conditions. At the same time full service of the sovereign debt is insurmountable for the Russian economy. A deep restructuring of the debt is needed, which is only possible with a general reforms program in place.

Introduction of new financial instruments

Extension of the choice of financial instruments, classified by risks and return, is one of the most critical directions for revitalizing the Russian securities market.

Specific attention must be paid to the development of the corporate bonds market which allows owners to attract investments without losing control over the enterprise. Besides, taking into account the real situation in the Russian economy, the introduction of the following instruments is very promising:

- warehouse certificates;
- securitization of obligations of enterprises and issuance of commercial papers
- long-term mortgage securities with maturity of 10 years and longer.

The above market segments will require an appropriate legal basis which is currently in the inception state.

Improvement of the legislation

Improvement of the legislation will require some efforts to overcome the "patched" nature of the legal system of the Russian securities market, in particular

In the area of corporate governance:

- The adoption of legal standards that provide for the unhindered dismissal (removal) of top managers, as well as the confiscation of assets belonging to top managers, in the event that they violate the rules of corporate governance.
- A ban on insider trading.
- An explicit definition of transactions with affiliated parties.
- Expansion of information disclosure requirements and liability for the content of information that is disclosed.
- Regulation of capital dilution (including through the introduction of mandatory preferential rights for shareholders).
- Restrictions on "cross shareholding."
- Introduction of direct liability on the part of officials, directors, and controlling shareholders for damages sustained by a joint-stock company itself or its shareholders (up to and including criminal prosecution);

In the area of information disclosure:

- tightening of the liability for failure to disclose information or to provide investors with logical information;

In the area of stimulation of investments inflow and lowering investors' risks:

- adoption of the Law on Investment Funds;
- development of the legal basis for compensation funds;

Amendments to the Criminal Procedural and Civil Procedural Codes (which provide for more effective protection of purchasers of securities who are acting in good faith and the introduction of the institution of class-action suits):

- adoption of the legal basis for the activity of the Central Depository, etc.

The role of "trade-unions" for investors

The experience of investors in Russia shows that only energetic efforts to protect their own interests produce meaningful results. A number of key points can be identified in investors' activities which will help ensure success:

- a more thorough approach to due diligence than in other countries prior to the implementation of investment;
- active efforts to protect their own rights (including the use of the mass media and appeals to government and court authorities);
- joining forces with other investors, including through the creation of associations (unions) for investors, since this helps to cut costs and enhances the effectiveness of measures being taken.

The passivity of Russian governmental authorities, weakness of courts, insufficient powers of the FCSM are natural reasons for the establishment of "self-defense" organizations.

There are a number of organizations in Russia today representing the interests of investors and shareholders. In the majority of cases, however, they are small in scale and serve private individuals exclusively. Such investors are characterized by relatively small-scale investments and are united, primarily, by their effort to find and recover money invested by them in pyramid schemes from 1993–1995.

A new phenomenon that appeared in 1998–1999 was the gradual unification of large investors, including institutional investors, which initially grew out of the NAUFOR Program to Protect Investors' Rights, and was followed in October 1999 by a prototype of the future "trade union" (association) of shareholders (investors) within the framework of the Coordinating Center for Protection of the Rights and Legal Interests of Investors (currently - the Investor Protection Association).

Today under the auspices of this Association a number of large foreign and domestic investors (there are more than 20 now, with a total volume of investments in Russia of US\$10 billion) have joined forces and resources in the campaign to defend their rights, converting the communists' well-known slogan to fit their own purposes: "Investors of all countries in Russia—Unite!".

Improvement of the market regulation

From 1995-1998 Russia made a quality breakthrough in securities market regulation:

Table 3. Expansion of the Activities of the Federal Securities Commission

	1995	1996	1997	1998
Number of Employees	22	75	477	824
A. Federal Securities Commission	22	75	130	193
B. Regional Branches of the FCSM	-	-	347	631
Number of Regulations Issued	21	23	45	53
Investigations and Reviews (all types)	79	92	710	1,872
Participation in Court Proceedings	-	-	-	124
Cases Referred to Law Enforcement Agencies	-	23	984*	130
Securities Issues Registered	-	-	3,265	19,848
Securities Issues Prospectuses Rejected for Registration	-	-	322	2,612
Licenses Issued or Renewed to Market Participants	1	203	3,498	1,434
Licenses of Market Participants Annulled or Suspended	-	-	62	349

* *Includes "pyramid scheme" cases*

The development of market regulation in 1999 was not characterized by the growth of the number of inspections (the number remained roughly the same), but rather by the sudden complication of problems resolved: the most indicative case is the conflict between the FCSM of Russian and YUKOS Oil Company, which demonstrated that further progress of the regulatory system is impossible without resolving the overall problem of reform of the State and its court and law enforcement systems.

The following new objectives form an integral system of market control:

- the system of regulatory authorities with clearly defined powers and responsibilities, criteria of relationship with market participants, transparent hierarchy of inter-agency relations;
- detailed descriptions of standards of activities of market participants, investors rights, and types of violations;
- a widely diversified system of sanctions.

The emphasis should be shifted towards protection of shareholders and investors rights against violations on behalf of issuers.

Conclusion

Russia is not a unique country. The young Russian securities market is not unique either. This "kid", born less than 10 years ago, grows fast, strengthens its immune system, has already been "infected" with some usual diseases of a young market ("pyramid-building", pumping up the governmental securities market etc.) and developed some immunity against them. It is as volatile as any other emerging market, it is as risky, and its problems can be identified and resolved, but the solutions will be forthcoming based on the resolution of some more generic problems of reforming Russia.