

The emerging securities market in Russia

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Introduction

Developing countries in general and Russia in particular have been importers of international capital since their real investment needs tend to be large relative to their level of income and savings. The main source of these flows has been surplus savings in the industrial countries and project financing from multilateral agencies such as the World Bank and European Bank for Reconstruction and Development.

The Russian equity market began to take shape in the second quarter of 1994 following the peak of the privatization program launched in 1993. The first market to attract significant funds from international investors was the market for privatization vouchers. With the expiration of vouchers the market for shares in privatized enterprises developed in major Russian financial centers.

The market's development has continued apace since 1994, but even at the end of 1995 portfolio investment in Russia was relatively insignificant. Global investors and financial institutions reassessed Russian investment opportunities in the second half of 1996 and since that time the equity market has come to occupy a dominant position in the Russian economy. After overcoming a period of marked undervaluation, the market moved from an intensely speculative and volatile infancy into its youth as a respectable emerging market. Investor interest has continued to spread throughout a broad range of industrial sectors, and increasing attention is being paid to second tier stocks as well.

Trading volumes rose significantly in 1997 and institutional money joined hedge funds as important market players. By October 1997, foreign investment in the domestic T-bills (GKO) and equity markets was up dramatically with 6 billion dollars poured into ADRs alone. Daily volumes on the Russian Trading System (RTS) were up 5-10 times over 1996 volumes. Another 165 percent rally to October 1997 has confirmed the significant revaluation. Even after a recent crisis the Russian equity market still presents one of the best performers among emerging markets and has a great growth potential.

Legal environment and government bodies in charge

The legal environment remains one of the most contradictory issues for the Russian financial market. On one hand, the regulatory structure of the stock market has grown from nothing to a mountain of documents regulating even such small market details as exam requirements for traders seeking securities trading licenses. The first law dedicated to the Russian securities market appeared only on December 28, 1991 and since that time, the Russian government has been constantly working on the improvement and expansion of securities law.

On the other hand, Russian securities law, instead of bringing about a compromise between government, business and investors, seems to have become a battlefield for the three Russian regulatory bodies involved: The Central Bank of Russia; The Ministry of Finance paired with The Federal Tax Service; and The Federal Commission for the Securities Market (FCSM). In other words, Russian securities legislation is more the fruit of politics than the result of rational work directed toward organizing the markets in the most efficient way.

The Russian legal environment functions as follows. In November 1994, the President of Russia approved a decision to form The Russian Federation Commission on Securities and the Capital Market (SEC) (the predecessor of FCSM created in July 1996), which was to be vested with full rights to handle all securities market developments. In theory, the FCSM possesses outstandingly strong legal power: it has the status of a ministry; a bureaucracy of 117 employees (most of whom were formerly with the State Privatization Agency, GKI); it is legally superior to any other government body, including the Central Bank of Russia, regarding the regulation of securities markets.

Generally speaking, the key functions of the FCSM are the harmonization of existing securities laws and the development of further regulation and supervisory activities for the entire market and related government, commercial and non-profit bodies. In fact, the FCSM (formerly SEC), having been established almost three years after the onset of the market's development, was and still is in the position of having to prove its ability to regulate the markets to the financial community.

It appears that the most serious battle to be won or lost by the FCSM is the battle with the Central Bank of Russia for market regulation responsibilities. The Central Bank of Russia is still pretending to regulate every type of commercial banking activity, including those

related to the securities markets, as well as keeping control of all regulation related to issues of capital export/import known as “Currency regulations.” It should be noted that the two largest Russian financial markets—the foreign exchange market and the market for T-bills (GKO)—are fully regulated by the Central Bank. This fact quite logically creates a painful market conflict between the FCSM and the Central Bank of Russia, as both agencies are supposed to regulate a number of the same issues.

However, on a positive note, it should be mentioned that both institutions are ideologically run by young technocrats who, during the last year, have already made considerable progress in putting the two bodies into cooperation and in developing a new basic securities law, as well as several other joint regulatory acts.

The Ministry of Finance appears to be a very passive regulatory body which merely handles the responsibilities of the borrower for the government, coordinates tax, reporting and registration issues, and which leaves all initiative, in terms of market development, to the Central Bank of Russia and the FCSM.

Despite the unclear division of regulatory responsibilities, the market has continued to develop. However, development of the market would be faster if three key legal restraints were removed. The first of these is the inefficient taxation system. Irrational taxes are to be blamed for virtually all of the major problems of the market. Thus the alarming underdevelopment of domestic institutional investment funds and the consideration of capital gains on equity investments as profits, with the consequent application of a punishing 38-45 percent Russian profit tax on such capital gains. This treatment of capital gains has an even greater impact on the desire of foreign investors to purchase Russian stocks: foreign investments in equity in Russia could appreciate in ruble terms and be taxed for capital gains, while, in dollar terms, the same equity positions could drop in value. The overall loss would be further aggravated by tax payments.

The second key legal restraint to further market development is the large gap between the written laws and their implementation. Disclosure practice and registration regulations provide the two strongest proofs for this statement. In theory, Russian laws carry many necessary provisions for disclosure rules and public reporting, as well as for the independence and transparency of registration activities. In practice, however, public and regular disclosure of information is produced by roughly only 15 percent of the top 300

Russian public companies. In addition, it is still very difficult to find registrars on the market who are not affiliated with the issuers or traders of stocks for whom they are handling the registration.

Finally, the third key legal drawback is the unclear regulation of foreign capital participation in the market. This issue is particularly sensitive for the future of the market for two reasons. First, foreign investments have been the major source of liquidity for the emerging Russian stock market for the past 2 years. Second, billions of dollars are sitting in the overseas accounts of Russian citizens which could theoretically be repatriated if clearer provisions for foreign capital participation in the market were established.

However, there are very contradictory tax and legal regulations for foreign investments in Russian stocks-and this is anything but encouraging. In addition to the aforementioned bad taxation system and weak disclosure requirements, these regulations create a very complicated technical procedure for investment through so called "I" accounts, which are to be opened with the Russian tax authorities. These regulations also provide no clear definitions for profits repatriation.

To resolve these problems, Russian professional market participants often maintain affiliated offshore companies to facilitate easy foreign currency settlement and avoid problems with unclear Russian profit repatriation legislation. If a Russian entity can provide off-shore settlement, the process may be completed without tax implications in Russia. Nevertheless, the majority of Russian equity transactions go through Moscow-based brokers and settlement of securities transactions is done off-shore as often as on-shore.

The current situation with on-shore settlements indeed speaks in favor of the off-shore settlement of Russian equity transactions. However, it is expected that general clarifications on capital transactions (including tax clarifications) will be soon forthcoming, particularly following Russia's ratification of Article 8 of IMF Charter on non-capital account transactions.

Market characteristics and marketplaces

The price discovery process is reasonably efficient although there may be some price distortions when large institutional investors overwhelm the bidding process.

The market is quite accessible both in terms of participation and transaction costs. The Russian Trading system (RTS) is operated by a self-regulatory National Association of Securities Traders and is the leading domestic market place for Russian equities. The RTS carries information on about 85 traded issues. The RTS launched a second-tier market in late 1996, the RTS-2, for trading in less liquid stocks. Nonetheless, traditional financing methods, such as bank borrowing, are the mainstay of the system.

The equity market is now characterized by the following features:

- rapid growth in the number of shares traded and issuers listed;
- development of the professional skills of domestic market participants;
- increasing interest from international portfolio investors;
- growth in liquidity and the launch of ADR and GDR programs for a broad range of Russian stock;
- continuing improvements to the market's infrastructure.

However, the market also faces continuing challenges, including:

- Russia's poor economic condition, which is further exacerbated by particular government policies (for example in the area of taxation);
- the small volume of domestic savings coming into the equity market;
- market infrastructure that, while improving, lags behind the infrastructure of established market;
- political uncertainty (albeit far from instability of mid-1996).

In the beginning, Russia was quite different from all the Central European markets in that it had no physical, centralized exchange for stock trading. In theory, there were more than 100 licensed stock exchanges throughout Russia. However, only a few of them reported on daily trading sessions with daily volumes. Furthermore, only the Vladivostok International Stock Exchange had the necessary infrastructure to handle organized trading with the stocks of Russian Far Eastern companies.

In fact, most trading with equities, with the exception of some limited trading at stock exchanges, was taking place on the over-the-counter market where deals were negotiated by telephone. This fact was responsible for one of the market's fundamental problems: the lack of day-to-day transparency in terms of real market prices for securities traded, as well as for trading volumes. Literally, no reliable benchmark prices for stocks or any reliable data on trading volumes was available.

However, the local financial community was expending substantial effort to develop an organized marketplace in Russia. As a result, one of the first most remarkable initiatives was the creation of a self-organized body called the Professional Association of Securities Market Participants (PAUFOR), which had more than 30 first-tier market makers among its members. This association developed a trading system—the Russian Trading system (RTS)—on the basis of NASDAQ mastered PORTAL software. Until January 1, 1996, this project was supported by USAID. Initially, the system linked the following cities: Moscow, St. Petersburg, Perm, Ekaterinburg, Chelyabinsk (Urals), Orenburg (South Urals), Novosibirsk (Western Siberia), and Irkutsk (Eastern Siberia). In the first half of 1996, the Russian Trading system was extended to Astrakhan (Southern Russia), Barnaul (Altay Region), Kazan (Tatarstan), Krasnoyarsk (Eastern Siberia), Kurgan, Nizny Novgorod (Central Russia), Omsk (Western Siberia), Rostov (Southern Russia), Surgut (Western Siberia), Toliatti (Volga Region), Tomsk (Western Siberia), Tumen (Western Siberia), Vladivostok (Far East), Volgograd (Volga Region) and Yakutsk (Northeastern Siberia).

In the beginning, the number of securities which were traded through the RTS had been rising quite slowly. Nevertheless, the Russian Trading System became the primary pricing mechanism for the OTC market. According to RTS officials, the system is accessible to members of market participant trading associations, who, in turn, are responsible for developing and enforcing the rules for trading on the system. RTS officials started reporting cases of these associations taking disciplinary action against members who violated trading rules. According to the trading rules established by PAUFOR, all quotes on the RTS were firm.

The Listing Committee of PAUFOR started developing new procedures for listing securities on the RTS, such as different types for securities with ratings dependent upon the size of a company's market capitalization, the conditions for registration of shareholders, and

the company's disclosure practices. Once a month, the PAUFOR Listing Committee reviewed the ratings of qualified securities. Ratings of any shares that failed to adhere to the necessary standards were lowered automatically.

Nevertheless, the Russian market was lacking an efficient system for small order executions. All equities were traded in blocks and brokers did not deal with small volumes (usually meaning those less than 15-20 thousand dollars). The reason for this was quite simple: dealing with stocks in Russia entailed incurring significant expenses for the registration of securities, location of an intermediary and delivery of shares. These expenses, in the majority of cases, could only be covered by bulk deals. Thus, the huge holdings of retail investors, formed within the popular privatization program, were cut from the secondary market, narrowing Russian stock market even more than it appeared to be.

During 1996, Russia's equity market infrastructure developed to unprecedented levels, and rules for market participants were firmly established by the National Association of Securities Market Participants (NAUFOR). Created by major market participants to build a trading system and develop market infrastructure, NAUFOR has grown into a country-wide, self-regulating broker/dealer association with more than 400 members. Today the Russian Trading system (RTS) has become Russia's principal market for equities trading with a daily volume averaging USD 60 million. RTS is the leading corporate securities trading system and the single most important development in the infrastructure of the equity capital markets. RTS system consists of RTS-1, composed of blue-chip stocks, and RTS-2, which quotes less liquid shares. RTS computerized trading system for quoting and trading, which consists of almost 100 stocks on level one, has made an important contribution to price transparency, increasing liquidity and assisting to reduce bid-offer spreads.

In general, the securities trading systems in Russia have been developing at a remarkable pace. Besides RTS, telephone and electronic trades can now be conducted through Moscow Interbank Currency Exchange, (MICEX) trading system for both equities and debt, the international information systems (Reuters and Bloomberg), as well as through smaller local information systems (e.g., Interfax Dealing).

Traders and investors

Privatization of productive assets owned by the state has been especially important in attracting FDI to Russia in the 1990s. According to the World Bank, 40% of FDI has gone to direct acquisition of privatized state enterprises. One reason for this is that such programs attract other investors through a “signaling” effect by indicating the government’s commitment to creating a favorable environment. In addition, privatized companies frequently require new investment to reconstruct, modernize and expand existing facilities. Available evidence suggests that such “follow-on” investment may exceed direct privatization revenues by a ratio of three-to-one.

In 1993, almost 100 percent of the stock trading in Russia was performed by domestic brokers and in 1994, CS First Boston and Brunswick, as well as several domestic banks, started absorbing their market share in trading volumes. In 1995, Russian brokers lost significant amounts of their business to foreign and domestic banks that had, by that time, developed a very strong presence on the market. Rapid market growth in 1996-1997 has led to the significant increase of number of both Russian and foreign market participants.

Stock trading groups in Russia are characterized by significant segmentation. The largest Russian banks (Alfa Capital, Menatep, Inkombank, Uneximbank, etc.) have formed very strong stock trading groups to handle stock trading on the block level, as well as stock trading on any level for mergers and acquisitions assistance purposes. The largest Russian brokers (Rinaco Plus, Troyka, Moscow Partners, Grant and others) appear to be remaining in the same types of principal activities. Foreign banks and brokers (CS First Boston, Morgan Grenfell, ING Bank, Brunswick, AIOC Capital) have developed their trading groups mostly for block trading operations, while the remaining hundreds of brokers are left to service second-hand orders and to develop the still underdeveloped retail market for shares.

However, new rules of licensing for operations in the Russian stock market were introduced in September 1997, under which directors-general and accountants of broker and dealer companies must be Russian citizens.

The key to understanding the liquidity of the Russian stock market is to look at who is actually investing in Russian stocks. One may distinguish several groups of participating investors. The first group is Russian domestic institutional investors. This group consists of investment funds formed with the help of voucher privatization (when vouchers were

collected from citizens and invested in stocks) as well as a new generation of investment funds; insurance companies and pension funds which still keep the bulk of their investment in short-term money market securities. Pension funds are also quite small in Russia in terms of their total assets compared to more developed markets.

The second group of investors is comprised of Russian industrial and financial groups (IFGs). IFGs always prefer targeted, aggressive investments, and aim toward acquisition when investing in securities.

The third group of investors are retail investors. Finally, the last large group left-foreign portfolio investors-seems to be still the most important facilitator in the development and growth of a liquid secondary market for shares.

Registrars, depositories and custodians

All equities in Russia are issued in book-entry, with ownership recorded in a share register held by the issuer's registrar. Indeed, prior to 1996 the issue of bearer shares was prohibited by law. The law on the Securities Market, promulgated in April 1996, empowered the FCSM to authorize the issue of bearer shares up to a specific percentage of company's charter capital. To date, however, the FCSM has not authorized any such issue. Significant concerns regarding bearer instruments still linger following several notable incidents of Ponzi schemes and other fraud occurring in 1993-94, and no issue is anticipated in the near future.

At present there are several organizations in Russia which maintain a joint stock companies register, e.g., the National Registry Company (NRC), founded by the European Bank for Reconstruction and Development, International Finance Corporation, the Bank of New York, the subsidiary register of LUKoil, the giant oil company, and UNEXIM Bank.

The principal problem with the registration process is that of access to the registrars located outside Moscow, which in some instances can prove to be quite complicated. In order to re-register a trade the market participant has to undertake long and frequent trips to distant regions across the Federation such as Vladivostok, Nizhnevartovsk, and others.

Problems arising from the complicated access to the local and remote registrars can be resolved with the availability of custody services. In particular, UNEXIM Bank, being the biggest Russian full service custodian, is able to efficiently process re-registration of

ownership rights for securities in any region of the Russian Federation promptly and at a considerably lower cost than other organizations providing similar services.

To date the concept of a centralized depository has still not been formalized in Russia. A number of formation projects, for example the Depository Clearing Company (DCC) and the Interbank Credit Union Depository projects, tried to tackle the problem but despite a strong advertising campaign were not successful. Recently two entities, the Depository Clearing company and the National Depository Center, a non-profit partnership owned by the Central Bank of Russia and MICEX (49% and 51% respectively), have agreed to work together on proposals for the creation of a centralized depository.

The experience of leading countries in the creation of a centralized depository service infrastructure demonstrates that the dynamic development of the stock market is impossible without an internationally acceptable depository and settlement system. The prevailing trend in countries with highly developed stock markets does not depend on national and regional factors. This trend appears as centralization of the depository functions that in principle meet the 'Group of 30' recommendations.

World practice demonstrates that the creation of a centralized depository structure appears on the stage when custodian banks fully develop their operations.

The number of custodian banks operating in Russia is so far fairly limited. This group includes three or four subsidiaries of foreign banks and a small number of Russian-owned banks. UNEXIM Bank recently confirmed its premier domestic status by signing subcustodian agreements with eminent global custodians like The Bank of New York, The Bank of Boston and ING Bank.

The development of Russian financial markets has been extremely rapid in recent years, which has in turn attracted keen interest from international investor community. Despite remaining deficiencies in the financial infrastructure, the emergence of dedicated domestic custodian banks will increase its efficiency and diminish settlement risk.

Information sources, market prices and indices

The information infrastructure appears to be the most developed component of the organized market in Russia.

Several pricing services (including AK&M, Interfax, Skate-Press, etc.) have been established on the market to provide market participants with daily average prices for all securities traded. However, it is still necessary to implement sophisticated averaging methodologies to obtain pricing histories for many instruments.

Several equity market indices currently exist for Russia. The most widely recognized ones are the RTS Index, the NAUFOR official index, and the MT Index calculated by the Moscow Times newspaper in conjunction with SKATE Consulting Agency. Other indices include the AK&M information agency and the Commersant newspaper indices. Several brokerage houses also publish their own indices, including Creditanshtalt-grant, the Russian Brokerage House and CS First Boston. The indices differ in almost all aspects of the methodology used. However, all of the indices are capital-weighted, with the weighting for particular stocks reflecting (with some adjustments) their market capitalization.

All major international compilers of emerging market indices, such as International Finance Corporation, Morgan Stanley and Barings, have launched Russian indices and included Russia in their global emerging market portfolio weighting. Consequently, a broad family of Russian indices has been created, from global benchmarks used by international asset managers to local in-house products. In addition, the Russian equities market will be included in the influential IFC Investible Index with a weighting of 4%-5%. It is also included in the Morgan Stanley International Index.

The largest international information groups (Dun & Bradstreet, Reuters, Bloomberg, AP-Telerate, Financial Times, Independent Media and others) are actively working to promote their services on the Russian market and to develop the local information environment. Information providers also appear to be the most important sources of corporate events and disclosure data, and sometimes even force Russian public companies to deliver this information publicly.

Types of securities traded, market capitalization

Market capitalization in Russia peaked at over \$30 billion which placed it close to Argentina's market size and higher than Turkey, Czech Republic and Greece. Monthly value traded hovers between \$250 and \$500 million.

On the equity side, common registered stocks are the most widely traded type of security. As it was mentioned earlier, there are still no bearer stocks in the market. The market also consists of preferred shares, corporate bonds, etc.

There are about 100 Russian public companies with common stocks traded on the OTC. More than 70 percent of the total market capitalization was provided by oil and gas stocks, with the five largest companies (Gazprom, LUKoil, United Energy System, Rostelecom, Yuganskneftegaz) representing almost 50 percent of the total market capitalization.

Today, the Russian stock market still remains overwhelmingly dominated by companies in three sectors—oil, electricity, and telecommunications. Currently, these companies still account for most of the total capitalization, while these enterprises account for only 20 percent of GDP. Within all three industries some diversification has taken place: while the bulk of capitalization was earlier concentrated in a few blue chips (LUKoil, Surgut, Rostelecom, MGTS, Mosenergo, and UES) a number of large regional players have now emerged on the scene. Although the top 10 stocks still account for more than two-thirds of deals done on RTS, regional companies like Nizhny Novgorod Svyazinform or Sverdlovenergo have started making a real impact.

In this sense the market has broadened, as new issues have been introduced, but it has maintained its overall uneven character. That trend is unlikely to change in the short-term, because the bulk of companies with strong asset value and good earnings are concentrated in exactly these sectors.

Significant and continuing restructuring of Russia's external debt has helped to reduce public sector external obligations. This in turn has led to improved local investor access to domestic resources and a generally favorable reassessment of the transfer risk that foreign investors attached to investment in Russia. This improves the risk adjusted returns foreign investors expect and makes it easier for the private sector to tap world capital markets and Russia in particular.

Recent developments

International capital flows become an increasingly important source of financing in Russia. At the microeconomic level these flows respond to differences in expected returns

across companies. At the macro level they respond to differences in the expected returns across industries.

The drop in Russian equity markets was more dramatic than in most markets in October 1997, but losses were relatively minor compared with Russia's total gains in 1996 and 1997. The crisis demonstrated that Russia is part of the world financial system since the volatility of trading on Wall Street in October 1997 was mirrored in the Russian equity market almost immediately. This has led some analysts to believe that there is a growing correlation between Russian and U.S. stock prices.

Nonetheless, by accessing international capital markets, companies in Russia have been able to reduce their ratios of debt to equity, thereby enhancing their resilience to adverse stocks and increasing their ability to mobilize additional resources for investment.

Conclusions and future prospects

Turmoil in the Russian equity market does not mean the end of its growth. In this exciting but volatile market there will be many downturns and rallies. The main reason for this optimistic view is the state of the Russian economy which finally shows signs of stabilization.

Since its beginning, the Russian stock market has seen dramatic changes. The market has been characterized by rapid growth, increased participation, but also widespread disorganization. Lucrative returns have been counterbalanced by volatility. While the market provides both foreign and domestic investors an opportunity to cash in on Russia's market privatization, Russia's tax and regulatory systems need much improvement in order for benefits to fully materialize.

Investors are attracted to Russia because it is resource rich, well-educated, undertaking significant economic reforms and has the potential to become an economic superpower. Unfortunately, complex tax rules and regulations are impeding development and deterring foreign investment.

Russia's stock market is evolving at a quick pace with high volatility. Major organizational undertakings are necessary for the market to develop in a positive and transparent manner. Fortunately, many investors, governments and international financial organizations are supportive and helping guide the market's rapid transformation. While the

market could be extremely lucrative if the reforms are successful, if they fail, investments could disappear.

Excess capital in international markets (especially after the crisis in Asia), government restructuring of the corporate sector and Russia's growing attractiveness in the eyes of global investors will create increasing capital flows into this country. While economic and financial trends are generally in the right direction, the speed, scope and final nature of Russia's transition will depend in large part on what happens at the regulatory, corporate restructuring and political levels.

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