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Abstract

This paper surveys the literature on ownership structure and corporate governance in Russia. The market structure is compared to traditional German and Anglo-Saxon market models. We argue that the Russian market constitutes a dynamic hybrid of the two models, i.e. its direction of development has yet to be resolved. As several current cases indicate, the risk of unfair treatment of minority shareholders in Russian companies is considerable. While we acknowledge that both the legal framework and the incentives of the management are equally important in protecting minority shareholder rights, the scope of the paper is deliberately limited to discussion of the legal framework. The information disclosure requirements of Russian companies are compared with the US requirements. Also the regulatory bodies in the two countries are discussed. Some differences between International Accounting Standards and Russian accounting practice are also reviewed. The final part of the paper is dedicated to the recent reforms proposed by the Russian government regarding disclosure and protection of minority shareholder rights.

Keywords: ownership structure, shareholders, information disclosure, FCSM, Russia

1 Introduction

The efficiency of a market can be measured by the amount of timely information available to its participants. The more efficient the market, the lower the transaction costs. The main objective of a marketplace is to combine efficiently and credibly (i.e. by protecting investors from unfair dealing and fraud) selling and buying interests in a way that optimises capital allocation.

Information flows can be divided into three types: public information mandated through laws and regulations, voluntary release of information and insider information. The more insider information needed to make an adequate evaluation of an investment, the lower the incentive of an outsider to invest (due to the higher costs of monitoring and higher risk of being cheated). The outsider's dilemma is how to make sure that insiders don't strip assets from the company, and that the decision-making process stays fair and transparent.

A common assumption is that insider owners[1] aspire to keep control of companies, but need outside capital. The insider's dilemma, therefore, is how to get outside capital for pursuing the management's plans and still keep control of the firm. When an outsider steps into the company, an agency problem arises between the firm and the new owner.

In the literature, outside financiers can be divided into those with the aim of "corporate governance by objective" and those with the aim of "governance by intervention." In corporate governance by objective, the financier take a "hands off approach" as long as the return on the investment is adequate. The financier does not interfere with the strategy of the company. Liquidity helps drive this approach; if the investor is displeased with the actions of management, he can readily sell his shares. Governance by intervention is a "hand on" approach, and control oriented as the concept implies.[2]

Corporate governance by objective needs transparent and liquid markets as well as high standards for information disclosure, as the object of the investor is not to take part directly in the decision-making process, but to stay within an arm's length of the operations of the company. The investor is ready to intervene as soon as he believes he is not receiving fair treatment. The control-oriented financier is less dependent on liquid markets and strong protection of minority shareholders' rights, as he is a block-holder[3] and takes part in the decision-making process. Control-oriented financing needs strong financial institutions (banks, etc.), that have strong capital bases.

The basic question of corporate governance is how to ensure fair treatment of the owners of a company irrespective of their objectives or whether they are insiders or outside shareholders. Obviously, the weakest position is held by outside minority shareholders. If fair treatment is secured for those in the weakest position, the risk of unfair treatment towards the stronger groups clearly also decreases.

To ensure fair treatment of shareholders it is necessary to secure adequate and sufficient information. The basic assumption here is that securing transparency itself represents a big step towards fair treatment of owners. Information is power in the world of investments. However, effective enforcement of laws and regulations does not in itself always secure transparency; insiders themselves should have incentive to disclose information. In this paper the emphases will be on what has been done to secure the information flow through laws and regulations, even though the incentives of the insiders are equally important as nominator for

[1] An insider is defined as the management and the employees that exerts control of the firm and are its owners at the same time.

[2] See for further reading E.Berglöf (1995), "Corporate Governance in Transition Economies: The Theory and Its Policy Implications" in M.Aoki & H-K Kim, Corporate Governance in Transitional Economies, EDI Development Studies, The World Bank, Washington D.C.

[3] A block holder is a shareholder with a significant ownership in a company. The blocking majority in Russia is currently 25 percent.

the success of protecting minority shareholders' rights. It could even be argued that in the case of Russia, where laws are often passed but not followed, the importance of insider incentives to disclose is even greater than the laws and regulatory framework.

Russia's massive, rapid privatisation of its economy without injection of new capital to companies increased the need for a marketplace where capital could be raised. To attract investors, a legislative framework for its participants became inevitable.

The development of the securities markets in Russia started in 1992 with Presidential Decree No. 721 "On Organisational Measures to Transform State-Owned Enterprises and Voluntary Associations of State-Owned Enterprises into Joint Stock Companies." The basic legislation followed in 1995 with the Civil Code of Russian Federation and the Federal laws "On Joint Stock Companies" (1995) and "On Securities Markets" (1996). In 1998, the government announced a wide program to further strengthen investors' rights. The program was originally to be implemented during 1998 and 1999, but recent events in Russia have cast uncertainty over the initiative.

In the following, we briefly discuss the market structure in general and the ownership structure of Russian companies. The shift from insider to outsider ownership of companies seems to fuel the development of the legislative framework. Next, we compare the regulatory organs of Russia and the United States. Third, we compare the information disclosure requirements of the two countries. We end with comments on the new program to protect investors' rights proposed by the Russian government. The choice of the US as reference is that the US market is often referred to as the most efficient market offering the best protection of minority shareholders' rights.

2 Market structure

Much of the literature considers markets and ownership structure of companies according to a "German model" or an "Anglo-Saxon model." In the Anglo-Saxon model (Heinrich 1998) ownership is highly diversified; there is little cross-shareholdings between companies and banks do not generally hold big stakes. This is to say that banks have little involvement in company operations. The incentives for management are built around a pay-performance scheme, whereby the better the performance of the company, the greater the financial enrichment of the management. The main resources of funding are the bond and equity markets; bank loans are not as usual. The Anglo-Saxon model requires extensive disclosure and high accounting standards, proper protection of minority shareholders' rights, rules that are favourable to the corporate bond market and a bankruptcy legislation that favours creditors.

In a German market model (Heinrich 1998) concentrated ownership structures prevail. Banks play a major role as stakeholders by taking part in corporate decision-making. Cross-ownership between firms is common, and households and institutional investors play minor roles as owners. Money is raised through bank lending, so the bond market is not seen as an important venue for raising funds. The German model is not characterised with as extensive disclosure and as high accounting requirements as the Anglo-Saxon model. The protection of minority shareholders is weaker and there are fewer barriers to large shareholders' activity than in the Anglo-Saxon model. However, under the German model, bankruptcy legislation also favours creditors.

In the Anglo-Saxon model, the efficiency of markets is crucial in the sense that new information is transmitted rapidly. Information about corporations is public and easily available (Dittus & Prowse, 1996). Furthermore, the availability of information between insiders and outsiders should be the same.

An adequate information flow is also crucial in the German model, but in this model a few large stockholders (banks and insurance companies, who are also insiders) perform the needed monitoring. This model requires adequate supervision from authorities in order to minimise the incentive for banks to give unsound or subsidised loans to affiliates with financial problems. Both the German and the Anglo-Saxon model make the basic assumption that the authorities are backed by the po-

litical will to refrain from acting as lenders of last resort and that competition is healthy (Dittus & Prowes, 1996).

The development of the Russian securities markets during the last few years suggests a development towards a concentrated ownership structure with weak protection of investors and strong insider influence. The capital markets in Russia are illiquid and there are apparent differences in the quality of the information flow to insiders compared to outsiders, making monitoring costly for outsiders. Furthermore, the banking system has been weakened severely by the financial crisis in August 1998. Yet, even before the crisis the banks were reluctant to invest in the real sector and, thus, do not play a major role as owners of the real sector. Another characteristic of the Russian banks is the strong link to major companies and, thus, the role of many banks becomes that of a mere company treasury. Please bear in mind here that restructuring of corporations involves difficult political decisions that can be avoided through natural mergers and acquisitions as is typical for the Anglo-Saxon model. Of course, for acquisitions and mergers to take place, transparency is needed. In other words, Russia's market structure is a weak reflection of the German model; it lacks owners with a strong capital base (i.e. banks) to invest in a restructuring process. These characteristics speak for a benevolent policy towards foreign investors.

However, as the most active foreign investors (especially portfolio investors with a "governance by objective" approach) are Americans, the influence from the Anglo-Saxon model has filtered through to Russia through their demands. Also, since the start of the development of capital markets in Russia, there has been close cooperation between the Russian Federal Commission for Securities Markets (FCSM) and the United States Securities and Exchange Commission (SEC). In 1995, the FCSM and the SEC signed a Memorandum of Understanding and a Protocol providing for regulatory and enforcement cooperation. Before that, the SEC provided technical assistance to the FCSM as the securities markets were developed in Russia.[4] The Russian Trading System (RTS), the main securities exchange, is based on the NASDAQ trading system in New York.

In summary, the Russian market fits neither the German nor the Anglo-Saxon model, but seems to be a hybrid of both.

3 Development of Russian corporate ownership structures after the first wave of privatisation

The first wave of Russia's privatisation program was launched in 1993 and was completed in 1994. The property rights to most large companies were distributed, mainly to managers and employees, but also to outsiders through auctions. After this initial phase of mass privatisation, the state began to make yearly lists of stakes in companies to be divested through auctions. The fastest phase of privatisation has ended, but the process continues to this day.[5]

This first wave of privatisation created ownership structures that heavily favoured management and employers. In a survey by Blasi, Kroumuva and Kruse (1997), 65% of 18,000 privatised companies were in the hands of insiders in 1994. Outsiders, including the state, owned only 34%. Interestingly, by 1996, insider ownership had fallen only to 58%. The employees share remained steady, while management shares fell from 25% to 18%. The share of outsider ownership increased from 21% to 32% and as expected the state decreased its ownership from 13% to 9%.

As the profitability and investment needs vary greatly across the companies inherited from the Soviet Union, the question arises

[4] see Hunt, Isaac (1997). Speech at the seminar "Securities in the U.S and Russian Stock Markets"

[5] Federal government revenues from privatisation were 7.2 trillion roubles (old) in 1995, 12.3 trillion projected in 1996 and 18.6 trillion in 1997. The target for 1998 is 17.5 billion roubles (new), see Bush (1998)

that is the reason for firms still being insider owned low profitability or are there entrance hindrances for outsiders? I dare say the answer is both. Looking at only the 50-100 largest companies the ownership picture changes. Blasi (1997) found out that there is a significant outsider ownership in Russia's 100 largest corporations, and most of them are majority outsider-owned. The average stake of a Russian outsider was 40 %, a foreign outsider 16 % and a Russian insider 22 % in 1996. Managers reported an average stake of 6 %. Indeed, this result is significantly different from the survey that included 18 000 companies, where the insider ownership was 58 % in 1996. Furthermore, Blasi found out that of the 100 largest firms in Russia 39 % of the block holders were without representation at the Board of Directors. Of the foreign block holders 75 % and of the domestic block holders 23 % were without representation at the Board of Directors. The lack of representation at the Board of Directors could partly be substituted with transparent markets, standards for information disclosure and an efficient regulatory authority that can defend shareholders' rights, if the shareholders aim is "governance by objective."

Assuming that companies listed on a stock exchange do have an incentive to raise capital through share issues or issue debt securities it could be expected that the outside ownership of the companies included in the Moscow Times Index 50[6] (MTI-50) has an above average outsider ownership. And indeed, in 98 % of the MTI-50 companies there was at least one registered outside owner at the beginning of 1998. The Russian outsiders owned 57 %, foreign outsiders 12 % and the state and regions 14 % of the total share capital. The average stake of a Russian outsider was 58 %, of a foreign outsider 19 %, of the state 35 % and of the insiders 29 %.[7]

The ownership structure seems to be developing towards more outside ownership. However, somewhat disturbing is that the share of employees has not decreased as much as what could have been expected, where as the share of the management has significantly decreased. The question arises that do the management own significant amount of shares in one or more of the outside owners? In this case the outsiders would be insiders, and it would not be taken into account in these surveys.[8]

How does the ownership structure affect incentives to respect shareholder rights? Willer (1997) argues that, first, management (insider owners) tends to have different incentives than formal owners. If the objective of the management, in a mainly insider owned company, is to keep control, decisions of restructuring tend to be inefficient when the restructuring requires outside capital. The problem can be mitigated through either enforcement of law and regulations or self-interest from the management as the return of investment outweighs the utility-loss of reduced control. However, Willer's model suggests that if the outside shareholder is big enough, it can either collude in stealing from the company or press for shareholder rights. Estimations of the model imply that when an outsider's stake exceeds 42%, shareholder-friendliness starts to decline. This empirical finding suggests that the market model with concentrated ownership, discussed in the previous chapter, is inefficient in respect to incentives to restructure.

Findings by La Porta, Lopez-de-Silanes, Schleifer and Vishny (1996) suggest that the accounting standards used are a critical input into the law enforcement of investors' rights. Further, high ownership concentration leads to weaker protection of investors' rights. High accounting standards, high rule of law and developed shareholders' protection is negatively correlated with high concentration of ownership. This means that if shareholder protection is weak, companies will not be able to rise money from a wide group of investors and entrepreneurs are not able to diversify their holdings. High ownership concentration may

[6] The Moscow Times Index consists of the 50 major companies according to their size and share turnover on the Moscow Stock Exchange.

[7] The data for MTI-50 is received from the SKATE financial services

[8] see R. Frydman, K. Pistor and A. Rapaczynski (1996) for further discussion of the subject.

thus be a symptom of inefficient capital markets.

In Russia ownership is still highly concentrated, indicating poorly protected shareholders' rights. Admittedly, ownership structures have become somewhat more diversified during 1996 and 1997 and the Russian government has made efforts to strengthen laws and regulations concerning shareholder rights.

4 Regulatory authorities in Russia and the US

The basic regulations of the Russian Federal Commission for Securities Markets (FCSM) and the United States Securities and Exchange Commission (SEC) are strikingly similar. Of course, the FCSM has functioned only four years, whereas the SEC has been operating for 64 years.

4.1 The Russian Federal Commission for the Securities Markets (FCSM)

The Federal Commission for the Securities Markets (FCSM) was founded in November 1994 on the basis of Presidential Decree no. 2063 "On Measures for the Governmental Regulation of the Securities Markets in the Russian Federation" to ensure that regulations are followed and shareholder rights upheld.

The aim of the FCSM is to ensure the functioning of the different markets in Russia as well as to set the guidelines for further development. The FCSM has issued stock exchange licenses to nine stock exchanges, of which three operate in the Moscow area. Licenses were given to Russian Trading System (RTS), Moscow Stock Exchange (MSB), Moscow Interbank Currency Exchange (MICEX), St. Petersburg Stock Exchange, St. Petersburg Currency Exchange, South Ural Stock Exchange, Siberian Stock Exchange, Vladivostok Stock Exchange and Saratov Stock Exchange. The securities on these exchanges are to be traded on regular bases and in accordance with internal rules of the exchanges.

The FCSM approves or revokes licenses of professional participants in the securities markets and self-regulatory organisations (SROs). Currently registered SROs are the National Association of Securities Market Participants (NAUFOR) and Professional Association of Registrars, Transfer Agents and Depositories (PAUFOR). The SROs sets mandatory rules for their members regarding activity on the securities markets and standards for the actual transactions. The FSCM has given the Bank of Russia general authority to license credit institutions (i.e. banks) operating in the securities market. Since June 1998, the FSCM has also overseen licensing of trading in derivative instruments. The requirement of a license from the FSCM for trading in derivative instruments was established after the bankruptcy of the Russian Exchange (RE).[9] In the battle for power surrounding RE's demise, the Moscow Stock Exchange (MSE) succeeded in nabbing RE's most lucrative businesses. However, as a consequence of RE's collapse, the FSCM rules that no bourse may trade in derivative instruments without a license.[10]

Furthermore, the FCSM is involved in the legislature process of the securities markets, but only as an adviser. The FCSM maintains a register of issued suspended and annulled licenses.

The FCSM supervises the compliance of the federal laws and regulations by the market participants and SROs.[11] In spring 1998, the Duma approved the first reading of a new law to widen the authority of the FCSM to issuing fines. While this law is still not in force,[12] the FCSM today can issue binding directives, suspend licenses or submit offenders of the legislation to penalties stipulated by the law

[9] The Russian Exchange was a pure futures and option trading house.

[10] SKATE Capital Markets Russia, 23 June 98, p.12.

[11] FCSM "Clarification of the role of the Federal Commission for Securities Market in Regulating the Russian Capital Market" (1997).

[12] Reuters 08.04.98.

through a court order.[13] In comparison to securities market authorities in the developed markets this is a rigid system, as the court decisions are slow, even for small or obvious infractions. Investors, particularly, are not happy with this arrangement. They want the FCSM to have the authority to impose fines and initiate investigations and hearings against offenders of the legislation.

The role of the FCSM has grown increasingly important during the second wave of privatisation.[14] In 1996 and 1997 there were several share issues, where violations of investors' rights took place. These would have gone unnoticed without FCSM intervention. For instance, in April 1998 the FSCM made public three cases where shareholders' rights had been violated. In January 1997, the LUKoil oil company violated the law on securities markets by allowing placement of both common and preferred shares by closed subscription. In January 1997, the construction company, Spasskcement held an issue without specifying the period of placement and without a prospectus bearing the stamp of the issuer, the auditor or FCSM approval. Later that year, the shipping company Prisco failed to register and disclose sufficient information about its share issue.[15] The FCSM keeps a list of companies that have violated investors' rights by not disclosing enough information about their operations. Twenty companies were on the list as of June 1998.[16] The FCSM takes a negative view of a decision by the Duma (May 1998) to restrict the foreign ownership in the Unified Electric Systems, UES.[17] The FCSM applies the rule of registration also to the Central Bank of the Russian Federation and the Ministry of Finance. At the beginning of September 1998, the FCSM declared a planned 2-week bond illegal because it was not registered by the FCSM.[18] Thus, based on its track record, it appears that the scope of the FCSM's powers to regulate extend beyond those of the SEC. The compulsory registration of Federal and domestic government bonds are excluded from the influence of the SEC.

The FSCM puts up standards for securities issues, but the rules for accounting and reporting are established jointly with the Ministry of Finance. The FCSM ensures the disclosure and accessibility of information by the issuers. The FCSM is also in charge of issues outside the Russian Federation.[19]

4.2 The US Securities and Exchange Commission

The United States Securities and Exchange Commission (SEC) was created under the Securities Exchange Act of 1934. Under the law, the SEC is an independent, non-aligned and quasi-regulatory agency. The objective of the SEC is to administer federal securities laws. The SEC issues rules and regulations to protect investors and ensures fair and honest securities markets. The SEC advises in federal courts in corporate reorganisation under the Bankruptcy Reform Act of 1978. The SEC reports to the US Congress.

The objectives stated by the Securities Act of 1933 are to provide investors with sufficient information on securities offered to the public and to prevent misrepresentation, deceit or fraud. Disclosure of information is achieved by registering offers of securities. Federal and domestic government debt securities are excluded from the compulsory registration. The efficiency or profitability of a corporation is not valued when applying for registration, only the correctness of the information disclosed.

[13] Rossiskaya Gaseta "O rinke tsenyi bumagyi" 20.03.1996.

[14] Generally referred to the period after the initial voucher privatisation.

[15] Russian Financial News, 13.04.1998.

[16] Reuters, 17.06.1998.

[17] The Duma decided to restrict the foreign ownership of the UES to 25 percent. At the time of the decision foreigners owned approximately 30 percent of the UES.

[18] Russian Financial News, 01.09.98.

[19] Rossiskaya Gazette "O rinke tsenyi bumagyi" 20.03.1996.

The Securities Act of 1934 is the basis for trading and sales practices on exchanges and for the conduct and registration of exchange participants. In a 1938 amendment, the status of self-regulatory organisations (SROs) was legislated. The intention was that SROs would establish self-regulatory measures to ensure fair dealing and investor protection.[20]

The Public Utility Holding Company Act of 1935 directs company restructuring, acquisitions and issues of shares. The SEC evaluates share issue proposals to ensure that the security has a reasonable structure, that the issue is in line with the earning power of the company, that the issue is needed, that the attached payments are not unreasonable and that the terms are not harmful to the public.[21]

Further laws that regulate the market and are responsibility of the SEC are the Trust Indenture Act of 1939 (bonds, debentures, debt securities etc. offered to the public), the Investment Company Act of 1940 (professional companies investing, reinvesting or trading securities) and Investment Advisers Act of 1940 (regulations applied to investment advisers).[22]

If the facts indicate a violation of SEC laws or rules, the SEC can, depending on the seriousness of the violation, either take civil action by applying to an U.S. District court or apply an administrative remedy. Administrative remedies include suspension or expelling of members from exchanges, suspension or denial of registration, reproach for misconduct or exclusion of individuals from SROs' (permanently or temporarily).[23] The Division of Enforcement at the SEC is in charge of all enforcement activities.[24]

[20] Office of Public Affairs, Policy Evaluation and Research, United States Securities Commission, "The Work of the SEC" , 1997, p. 5-7.

[21] Ibid. p. 8-10.

[22] Ibid. p. 10-12.

[23] Ibid, p. 18.

[24] Office of Public Affairs, Policy Evaluation and Research, United States Securities Commission, "About the Division of Enforcement" , 1996.

4.3 Summary of FCSM and SEC duties

Duties	**FCSM** (established 1994)	**SEC** (established1934)
Licenses	Stock and derivative exchanges, professional participants, SROs, securities issuers. The financial institutions are licensed by the Central Bank	Stock exchanges, professional participants, SROs, securities issuers besides Federal and domestic governments
Enforcement	Suspend or deny licenses, directives, reproaches, through court orders fines and other penalties	Suspend or deny licenses, directives, reproaches, fines, initiate court procedures, representation of investors in court, stop orders, trading halts
Legislature	Adviser in the legislature process, supervision	Adviser in the legislature process and in federal courts, supervision
Other measures		Require delicate information, impose restrictions on initial margins

5 Information disclosure

5.1 Information disclosure under the Russian Federation's 1996 law on securities markets

A company that issues securities in Russia is governed by the "Law on Securities Market" of 1996. The Law stipulates that issuing companies are responsible for disclosing the following information to the public:

1. Information about the issuer of the security, including contact information, share of capital owned by the board of directors, subsidiaries owned and a list of all owners with stakes larger than 20%.
2. A balance sheet with profits or losses from the three previous years and an account of the previous financial quarter. Reports on reserves or corresponding accounts and an investment plan for free own assets have to be included. Additional reports are to be included if there has been an increase /decrease of assets that represents 10% or

more of total capital and/or if the profit/loss exceeds 20% of total capital.
3. Information on issues planned or issues carried out.
4. Changes in the parent company or its subsidiaries if the value of assets changes more than 10%. An extraordinary profit/loss that exceeds 10% of total profit/loss. Separate review of an owner holding more than 25% of the share capital. Date of closing of the register. Date of execution of debt by owners to the issuer. Decisions made at the annual meeting, etc.

In the first point, the share of capital owned by the Board of Directors refers to direct ownership of the company in question. The shares owned by the Board of Directors in other companies are not requested. This could mean that the actual interest of a member of the Board of Directors might be greater if he owns shares in a company holding a stake in the company in question. A description of the management, including their share of ownership is not required. The transparency of the management's share holdings is important in order to evaluate the impact of insider ownership. The thought here is that the insider holdings are higher than the ownership list suggests when the management is a major shareholder in the company they manage.

In the second point, a problem from an investor's point of view is that the balance sheet is usually done according to the Russian Accounting Standard (RAS). The problem arises, as the aim of the RAS is first and foremost the tax authorities, not the investors. The differences between the RAS and the International Accounting Standards (IAS) will be briefly discussed in Chapter 6.

The quarterly report has to be published and delivered to the FCSM, or its representative, no later than 30 days after the end of the report period. The quarterly report has to be submitted to share owners if requested. The cost of the quarterly report should not exceed the cost of publishing.

Information that affects the result of the company should be disclosed to the FCSM no later than 5 days after the event occurred. Owners with stakes of 20% or more have to be reported (i.e. "flagging") and reported again whenever their holdings increase or decrease by 5% or more. The FSCM must be informed of any such changes within 5 days.[25]

5.2 1998 reforms in disclosure requirements

Problems recently addressed by the head of the FCSM include:

1. The lack of transparency in new share issues.
2. The use of closed issues to dilute shareholdings of outsiders.
3. Directed closed issues to a small group of investors at an issue price below market price.
4. Last-minute notification to shareholders before the start of the issue, so that they don't have time to react.

To avoid the above-mentioned problems, the FCSM now requires, in accordance with Resolution No.9, that shareholders receive the information a month before the registration of the prospectus at the FCSM or one of its regional offices. This allows shareholders to require corrections of the document, if it involves measures that violate their rights. Further, decisions on the conditions of an issue have to be made at a general meeting of shareholders. Before starting an issue, a company with more than a thousand shareholders has to dispatch a list of owners and an independent outside evaluation of the company's assets to the FCSM.[26] In all new share offerings, the minutes from the general meeting of the Board of Directors, where the decision was taken, have to be submitted to the FCSM.[27]

In April 1998, the FCSM approved new rules for disclosure in the event of a new share

[25] Rossiskaya gazyeta "O rinke tsenyi bumagyi" 20.03.1996.

[26] Belyayev (1998).

[27] Resolution No. 9, FCSM (April 1998).

or security issue. The new rules are supplementary to the Securities Markets Law of 1996. Resolution No. 9 distinguishes between joint-stock companies with more or less than one thousand shareholders and between a closed and open share issue.

The information requirement applied to a share issue with an open subscription arranged by a joint-stock company with more than a thousand shareholders is my first case. In the other three cases only differences from the first case will be treated. In the first case it is required that, when the decision of a share issue is taken, the company has to publish a full description of the issuer (i.e. itself), the type of securities, and the quantity, the time-schedule and conditions for the issue. It has to be clarified which authority took the decision and shareholders' use or non-use of their priority right (if non-use, the date of general meeting when the decision was taken has to be mentioned). After registration the company is required to publish the registration authority, date of registration, number of registration, quantity of shares offered, conditions for the offering, location and procedures for informing about the issue prospectus. The prospectus has to be sent to shareholders and the FCSM one month before the start of the issue. On expiration of the issue, information on the starting and ending date of the issue, quantity of placed securities paid for, actual offering price and quantities placed at each offering price, percentage of securities placed, major transactions related to the offering are required.[28]

In the standard prospectus of an issue, according to the Resolution No.19 of the FCSM, information is also required pertaining to the depository of the issuer, an investment declaration, main investments and general developments in the issuer's market of investment instruments. A historical review and the plans for future activity of the issuer should be included. Furthermore, operations and their share in gross income and future liabilities, and main competitors should also be mentioned.[29]

In an open subscription where the number of shareholders of the joint-stock company is less than a thousand, the difference compared to an open subscription with more than a thousand shareholders is that there is no requirement for a list of owners and an independent evaluation of the company.

Information to be disclosed in case of a closed subscription where the offering joint-stock company has one thousand or more shareholders is a list of suggested parties to whom shares are offered when the decision of the offering is made. After the registration of the offering, the parties expected to be offered the securities have to be published. The same information is required if a joint-stock company with less than a thousand shareholders decides to have a closed subscription. The joint-stock company with less than a thousand shareholders doesn't have to disclose a list of owners or accept an independent evaluation.[30] The Resolution No. 9 went into force on 25 May 1998. The new law will improve the incentives for investors to invest in joint-stock companies with more than a thousand shareholders, as even closed subscriptions have to be approved by the shareholders at a general meeting. To invest in a company with less than a thousand shareholders still seems to be risky or/and costly as there is no requirement for an outside evaluation of the companies' assets.

5.3 Information requirement under the US Securities Act of 1934 and SEC regulations

The information requirement for US public companies is generally considered tough. In addition to regulatory provisions that stipulate general requirements, disclosure is subject to common law precedents established in the courts. In this chapter only the law and some

[28] Ibid.

[29] Resolution No. 29, On Introduction of Amendments and Additions to Standards for Share Issues and Issues Prospectuses During Creation of Joint Stock Companies and Additional Issues of Shares and Bonds approved by Resolution No. 19 (September 17,1996), FCSM (October 1997).

[30] Resolution No. 9, FCSM (April 1998).

regulations are described in order to give a reference to the laws and regulations in Russia.

In the Securities Exchange Act of 1934, the compulsory information disclosure to protect investors was extended to all listed and registered companies for public trading on securities exchanges. Under the Act, the original registration file has to be updated with information from the annual financial statements and other periodic reports. Shareholders must receive all facts concerning matters on which they are asked to vote. Shareholders may also give proposals for a vote on an annual meeting. The "flagging" threshold, when control over a company is sought through acquiring shares, is 5%.

The Federal Securities and Exchange Commission (SEC) signs a listing agreement with all companies listed on a US stock exchange. Information compulsory to include in the registration prospectus is a description of the company's properties and business, description of securities to be offered and its relationship to the company's other capital securities, information about management as well as a financial statement certified by independent public accountants. If the information disclosed is insufficient, the SEC can announce a stop order.[31]

To discourage insider trading, the SEC requires the company to take special care when planning or negotiating corporate deals, changes in dividends, issues, etc. During negotiations, the stock behaviour is closely watched and if any extraordinary activity is seen in the market, the company must be prepared to give a public statement regarding its plans. A public statement is to be given immediately when delicate information is given to an outsider. The SEC can, if it sees it necessary, halt trading in a security due to information leaks or rumours. If the rumours in the market are false, the company must also make a statement denying or clarifying the rumours. To ensure published information is received simultaneously by all participants, the SEC may halt the trading in a security, about which information is published. According to the listing agreement the SEC can require delicate information from a company even if it's not otherwise made public. The SEC Surveillance Department monitors all markets and keeps the right to require information and a possible statement if some unusual movements or volumes in certain shares are seen.

The SEC recommends that companies keep "open door" policy towards shareholders, financial analysts and writers, etc. However, in discussions with these professionals the company is not allowed to disclose such information that has not been publicly disclosed. Information on advance earnings, dividends, stock splits, mergers or tender information clearly violates the SEC policy. If the SEC assumes an issue is trading on speculation, it can impose restrictions on initial margin or capital requirement to eliminate credits to market participants involved in intra-day trading.

An annual report has to be published and sent to the shareholders no later than 3 months after the fiscal year ends. The annual meeting can be scheduled 15 days after the annual report is sent out. The annual report is to be audited by independent public accountants. The report is recommended to include address of principal office, names of directors and officers, identification of the audit committee and other major committees of the Board of Directors, names and addresses of trustees, transfer agents and registrars, number of employees and shareholders.

No schedule is specified interim reports, but the reports should to be published without delay. Interim reports can be semi-annual or quarterly, depending on the listing agreement. The interim earnings statement must be prepared on the same basis as the company's annual financial statements.

Additional written notices have to be forwarded to the exchange if there are changes in accounting methods, changes of agencies (transfer agents, registrars, fiscal agents, trustees), amendments of charter or change in collateral. Any communication to shareholders should be forwarded to the exchange as well as changes in conversion, decrease in floating supply of stock or changes in directors or officers. Furthermore there is a long list of events

[31] Office of Public Affairs, Policy Evaluation and Research, United States Securities Commission, "The Work of the SEC" , 1997, p. 2-4.

that has to be reported to the exchange, for instance, disposition of assets if it affects the financial position, distribution of stocks and dividends, interim earnings statements, and legal proceedings.[32] The description of information that has to be disclosed to the shareholders, the public and the exchange is very thorough. The information requirement in the US is generally considered the toughest, which reflects the diverse ownership (households, investment funds etc.) structure of the companies.

5.4 Summary of Information Disclosure Requirements in Russia and the US

Item	**Russia (FCSM)**	**US (SEC)**
Flagging limit	20 %	5 %
General information	Shares owned by the Board of Directors, list of subsidiaries, list of owners with more than 20 %, a separate report on owners with more than 25 %	Information on the Board of Directors, trustees, transfer agents, registrars, number of employees and shareholders, list of owners with more than 5 %
Balance sheet	3 previous years including reports on reserves and investment plans for free assets	5 previous years
Issues	Information on previous issues	
Other information	Considerable changes in the asset value or profits/losses, details concerning issues	Changes in accounting methods, agencies and collateral, amendments in charter
Share issues	Distinction between companies with more than 1000 shareholders and less than 1000 shareholders, distinction between open and closed share issue. An independent outside evaluation if the company has 1000 or more shareholders	Financial statement certified by independent public accountants, description of the company and offered shares in relation to other securities of the company, information about the management
Time of report disclosure	30 days after the end of the report period	3 months after the end of the period (annual reports). No time specification for interim reports.
Disclosure of new information affecting the result	5 days	Immediately
Costs	Max. publishing costs	Max. publishing costs

[32] Disclosure and Reporting Material Information, Regulations of the New York Stock Exchange, 1998

6 Differences in Russian and International Accounting Standards

Commonly accepted accounting standards and adequate information disclosure are cornerstones in protecting investors' rights. Without constant access to proper and adequate information, the probability of management misusing their status rises. The Russian accounting standard (RAS) differs substantially from the International Accounting Standards (IAS), making it cumbersome for investors to assess the financial situation of a company.

The main difference between these two standards is that the RAS is cash based while the IAS accounts are predominantly accruals based. Under the RAS, a balance sheet and an income statement are required. The reports are used to calculate taxes and thus recorded at the Central Bank. This, of course, leads to a system that is tax authority oriented. According to the IAS a balance sheet, an income statement, a cash flow statement and disclosure notes are to be reported. The aim of the IAS is to give a financial statement to the shareholders not the authorities. The IAS also involves principles for judgement (for example, reliability, true and fair view, and determination of the ability to service debts) whereas the RAS relies more on "form over substance."[33] From the shareholder's standpoint, information gathered as a basis for tax reporting might not give a correct picture of the company's financial state. Most companies try to pay as little tax as possible.

Another difference is the treatment of bad loans. In the RAS, a bad debt can, after 6 months, be extended twice, after which it can be rescheduled by cancelling the old one and issue a new loan on the same amount.[34] This system of restructuring loans can be abused in the way that some "debtors" in the list of debtors reported are in fact unprofitable projects.[35] For instance, if drilling a new oil well fails, it becomes a cost without any future revenues. In this case the cost is not deductible, but the company would book the cost as "debtor." Clearly, the likelihood that this "debt" is paid back is non-existent. The IAS system contains provision for handling of bad and non-performing loans.

The third difference is that the IAS takes into account inflation when evaluating assets. Financial reporting in "Hyperinflation Economies" (IAS 29) is to be used when inflation exceeds 100%. The RAS does not consider hyperinflation.[36] Hyperinflation was not a problem in Russia during 1997 and the first half of 1998. However, as a result of the financial crises in August 1998, the risk of hyperinflation has grown significantly.

The short-lived "anti-crisis" program published on 23 June 1998 by the Russian government emphasised, among other things, introduction of IAS accounting rules, strengthening the independent audit function and improved financial controls.[37] Compulsory IAS reporting is to be launched for Gazprom, UES, railways and Transneft in the third quarter of 1998. All banks are required to report according to the IAS.

According to the government's program of investors' rights for 1998-1999, the standards for information disclosure regarding financial and non-financial statements would move to IAS, while taking the level of Russian development into account. The problem when implementing the IAS in Russia is how to estimate a "fair value" for an asset that do not have a real market value. Under the plans, the IAS rules would be in force from the fourth quarter of 1999.

[33] Arthur Andersen (May 1997).

[34] CenterInvest Group (October, 1997).

[35] Costs for projects that are not profitable are not deductible, which makes it rational to use them as bad loans instead in order to decrease the taxable profit.

[36] CenterInvest Group (April 1997).

[37] Reuters, 24.06.98.

7 The government's 1998-1999 program to protect investors

The Russian government and the FCSM have during the last years made an effort to improve investors' right. The turmoil in the Russian market that started in October 1997 and developed into a financial crises by the end of August 1998, has made it clear that without proper protection of investors there is no way to attract foreign nor domestic capital for investments or for government debt securities.

The government proposed a new law on protecting inventors' rights and interests on the securities markets to the Duma in July 1998. The program would be implemented during 1998 and 1999. The co-ordinator of the program is the FCSM. Given recent events, however, approval of the law in the immediate future seems unlikely.

The program is based on the revised law on joint-stock companies, the law on the securities markets of 1996, the law on foreign investors in Russian Federation of 1997 and the Presidential Decree No. 1008 from July 1996 "On Strengthening the Development of the Securities Markets in Russian Federation."

The main idea of the law is to improve the right of investors to require information from a joint-stock company that is planning a closed or open share issue. Under the proposal, an investor may require almost any information on a company planning an issue. The information disclosure requirements would be broadened and the infrastructure of the exchanges would be developed, for example, by developing the concept of registrars. Issuers or large shareholder groups cannot, in principle, influence registrars. The capital requirement of the registrars should also be sufficiently high to force consolidation to a very small number of registrars. Indeed, the beauty of a central securities depository is that it helps ensure an effective payment transfer system for securities, guarantees the ownership rights of securities, and decreases the risk of counterparty payment failure. Plans are also made for creating a new compensation model, where the power of the FCSM is increased and new model for taxation of investments.

In order to be allowed to carry out a share issue, the issuer has to register the issue and keep account of the outcome of the issue on a registered account. A closed issue has to be approved at a general meeting of the company by a two-thirds majority, unless the company articles do not specify some other majority. A shareholder voting against the issue or an absent shareholder can demand the company redeem his shares at a fair price or receive shares proportionally to his ownership. In the case of an open share issue where capital is paid in full, the company can use consideration in deciding upon the shareholder's demand for conversion. Also the company is explicitly responsible for any misleading information in its prospectus. The prospectus should provide an independent valuation of the company.

Upon demand by a client, any professional (listed companies included) in the securities markets is entitled to show a copy of its license to operate on the market, to give information about its organisation and to give an account of its capital. Any potential investor may also demand information about the registration authority, the registration numbers of share issues, a decision taken by the board of directors on a share issue, and the price development of the share during the last six weeks if the company is trading on an exchange. Professional market participants, in turn, are responsible for informing the investor about his rights to receive information. The cost of receiving the required information must be reasonable. Complaints should be directed to the FCSM.

The FCSM can use punitive measures against violators of disclosure obligations. The punitive measures include cancellation of licenses, administrative punishment, confiscation of assets or seeking of a court decision. The FSCM may encourage collective legal actions against a violator by investors. The FCSM can even represent such a group action in court, but the action has to be brought against a violator no later than one year after the violation. A fine given by the FCSM can range between 100 times the minimum wage to

1,000 times the minimum wage.[38] The FSCM can fine violations against the requirements for advertising, required documents or refusing additional information requested by an investor. The new measures will strengthen the role of the FCSM and other authorities of the securities markets.

The FCSM is currently the registrar of share issues and is entitled to refuse or cancel a given license for share issues. The investor might turn to the FCSM for questions or require a hearing. A recommendation by the FCSM is to be published.

If a member of an SRO violates the regulations on information disclosure, the SRO may impose sanctions, give recommendations or cancel membership rights.[39] Compensations to investors can be paid from an established mutual fund of the SRO. From 1 October 1998 all professional market participants must belong to an SRO. The FCSM controls the market participants, issuers and SROs and develops the role of the SROs as protectors of investors.

During June 1998 the FSCM has ordered regulations for investment funds in order to ensure investors of more information on the value of an investment fund as well as the assets held by it. According to the proposal investment and mutual funds would be required to register as joint-stock companies.[40] As a way to improve minority shareholders' rights, the program suggests more information, more liquidity, more controls and more compensation to investors whose rights have been violated.[41]

At this writing, the FCSM was ready to take on a more active role in preparation of laws and regulations in cooperation with the Central Bank of the Russian Federation, the Ministry of Finance and other legislative authorities.

8 Conclusions

While developments in the legislation of securities markets in Russia were brisk in 1997 and 1998, it now seems unlikely that the Duma will keep to its schedule for considering new legislation. Nevertheless, any Russian government must share the FCSM's concerns about improving market function and investor protection.

We have seen that the FCSM has clearly championed an Anglo-Saxon market model, so if it takes an active role in preparing new laws and regulations, the code of conduct it pushes for can be expected to resemble US or UK market rules rather than market rules elsewhere in Europe. Indeed, many FCSM regulations already resemble SEC regulations. Naturally, the US regulatory environment is better developed and more finely tuned than in Russia, but this could be expected given a half-century head start in regulation of securities markets.

One could, of course, ask if an "Anglo-Saxon," "German," or "Global" model will ultimately prevail in Russia. But no matter what market model is used, the main issue from the investor's standpoint will always be assuring fair access to reliable and accurate information. In Russia's case, its financial authorities must be allowed the necessary enforcement powers and array of suitable measures for this purpose. When investors can make their decisions to buy or not buy on the basis of reliable and accurate information, one of the most important prerequisites to efficient and liquid markets has been fulfilled.

[38] The impact of a fine this small does not have a great impact on the company economically.

[39] FCSM, Proekt Federalnovo Zakona (1998).

[40] Reuters news Service, 17.06.98.

[41] Rossiskaya Gaseta 25.08.98 "Gosudarstvennaya programma zascshity prav investorov na 1998-1999 gody "

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