RUSSIAN FEDERATION

ANALYSIS AND DIAGNOSIS OF THE FINANCIAL, REGULATORY AND INSTITUTIONAL POLICIES REQUIRED FOR

BECOMING AN INTERNATIONAL FINANCIAL CENTER

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Private and Financial Sector Development Department
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ACRONYMS AND ABBREVIATIONS

ADR	American depository receipt
ABS	Asset Backed Security
AMC	Asset management company
AUVER	Association of Members of the Veksel Market
CAI	Capital Access Index
CBR	Central Bank of Russia
CCP	Central Counter Party
CIS	Commonwealth of Independent States
EBRD	European Bank for Reconstruction and Development
GCI	Global Competitiveness Index
GDP	Gross domestic product
GDR	Global depository receipt
GFCI	Global Financial Centres Index
GKO	Russian government short-term paper
GUK	State Asset Management Company
IAS	International Accounting Standards
IGC	Innovative and Growing Companies
IMF	International Monetary Fund
IOSCO	International Organization for Securities Commissions
LBO	Leveraged Buy Out
MBS	Mortgage Backed Security
MICEX	Moscow Interbank Currency Exchange
NAUFOR	National Association of Securities Market Participants
NSPF	non-state pension fund
OECD	Organization for Economic Co-operation and Development
OFZ	Russian treasury bond
OTC	Over-the-counter
PARTAD	Professional Association of Registrars, Transfer Agents, and depositors
PFR	Pension Fund of Russia
RDR	Russian depository receipt
RTS	Russian Trading System
RVC	Russian Venture Company
SEC	Securities and Exchange Commission
SME	Small and/or medium enterprise
SPCEX	St Petersburg Currency Exchange
SPV	Special Purpose Vehicle
SRO	Self-regulatory organization
UAE	United Arab Emirates
VAT	Value added tax
VEB	Vnesheconombank

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Summary and Main Conclusions

1. There should be two principal goals in developing Russia as a financial center:

   A. Attracting more of the financial business of large enterprises and of the wealthy, which now largely goes abroad to other international financial centers.

   B. Serving the needs of small and medium enterprises and small investors in Russia—needs that are now largely unmet.

2. Advancing the second goal would help to advance the first goal by broadening the diversity in securities market funding as well as firm issuance possibilities. Financial centers exhibit benefits of scale. Better serving the need of SMEs and small investors would increase both the supply of securities and the demand for securities in Moscow. An increased volume and liquidity of transactions would make Moscow a more competitive financial center, thereby attracting more of the business of large enterprises and the wealthy that currently goes elsewhere.

3. Financial centers do not serve the needs of SMEs and small investors directly; they do so indirectly through financial intermediaries—banks, mutual funds, pension funds, and insurance companies. Thus the key to achieving Goal B is to impulse the development of a competitive system of banks and non-bank financial intermediaries.

4. In developing Moscow as a financial center, it must be remembered that financial centers are not created top down: they develop naturally if they are allowed to do so. Consequently, the focus must be on removing the obstacles.

5. The major obstacles are:

   i. dominance of state-owned and state-connected enterprises throughout the financial system.
   ii. barriers to entry of foreign financial enterprises and personnel.
   iii. an inadequate legal framework for financial activity.
   iv. an inadequate regulatory framework—in particular, excessive regulatory red tape and perceptions of "below board" rent seeking.

6. Obstacles (i) and (ii) (state connected banks, and barriers to foreign entry) stand in the way of developing competitive financial markets. They also stand in the way of developing a competitive system of banks and non-bank financial intermediaries.

7. Obstacles (iii) and (iv) greatly increase the cost of all financial transactions, directly reducing the volume of financial business. They also obstruct the innovation necessary for raising productivity and the introduction of new financial products.

8. While obstacle (iii) (the overall legal framework) should be given priority in terms of strengthening and incorporating best practice regulatory incentives, an option to consider in parallel, is *importing* a dedicated legal framework for a financial center that could, among other functions, serve investors from overseas as well as domestic investors using regulatory practices that are well recognized by international players. Dubai provides a model for how to do this. Importing a framework, however, should constitute one of several market development measures to, inter alia, attract capital to the Russian market. However, reforms in the domestic framework will nevertheless continue to be needed to exploit the full broad-based opportunities in the Russian retail market.

9. Obstacle (iv) (the regulatory and compliance framework) needs to be grossly simplified by balancing clear and predictable rules with sanctionable but measurable offences. Examining enforcement measures and their triggers used in established global centers' financial supervisors can provide an indication of which practices are most effective. Experience in established centers shows that regulatory obstacles can also be mitigated by relying as much as possible on self-regulatory organizations (SROs) while at the same time simplifying what remains of regulation by the state. However, for SROs to function properly the delegation of supervisory functions needs to be accompanied with the assumption of accountability and demonstration of their effectiveness in enforcing market discipline while promoting a fair playing field in market trading and ensuring accurate information disclosure. SROs will function based on their reputation being at stake in terms of effectively performing delegated supervision functions, a factor which requires a collective interest in maintaining high standards. Once such an approach is internalized by SROs, the government should seriously consider such a regulatory structure to incentivize the market.

10. Suggestions for new regulation should take into account the dominance of state-owned and state-connected enterprises among the issuers of securities. To start with, corporate governance in such enterprises needs to be made transparent in line with global standards while in parallel augmenting private sector participation. In the current context, suggestions for requiring greater transparency in the OTC market and for prohibiting insider trading will make little difference. However, more effective would be for beneficial end-owners of financial firms (public and private) to be subject to full disclosure of ownership and assets, as well as transparency, fit-and-proper and conflict-of-interest tests to obtain and retain a financial firm's license to operate.

11. While the state is overly active in certain areas, it not active enough in others and could provide a valuable contribution to capital markets development. The government securities

market is not widespread or deep since the Russian Federation has experienced a favorable fiscal situation for several years and required scant debt financing. However, lack of a government debt yield curve with sufficient liquidity in such instruments also hampers the development of the private bond market (and other fixed income instruments) given the absence of a risk-free yield curve to accurately price private sector bonds at several segments of the curve and provide a basis for broader use of money market and liquid collateral instruments. Provided it does not materially affect the government's fiscal soundness, the Russian Federation should consider the active development of multi-maturity liquid sovereign debt instruments.

12. Additional measures can be taken to modernize the financial infrastructure, legal framework and instruments supporting securities trading both within Russia and for cross-border purposes, as well as better exploiting electronic signature, transfer or securities ownership and legal settlement procedures; securities depository/custodial functions; reducing legal and structuring restrictions on mortgage securities; treatment of collateral; and securitization development in order to expand the range and depth of the capital market.

13. A shift in the overall market structure would be needed so that issuers, shareholders and investors may constitute more diversified players in all industries both at the retail and institutional levels. This would allow greater diversification of assets and provide a platform for an expansion of financial products at many more levels than currently exists.

14. Finally, the above actions would constitute the necessary conditions to have the key elements for developing a significant financial center. They may not be all sufficient measures however. Non financial market factors such as a suitable macroeconomic environment, efficient city transport facilities, reasonable housing availability, education facilities for foreigners, and a streamlined and transparent business regulatory environment all constitute key ancillary aspects supporting the growth and broader operating environment of international financial centers.

Part I. The Strategic, Economic, Global and Regulatory Context

15. *Section Synopsis: Part I of this report discusses the goals and characteristics of established global financial centers. It addresses the different market segments of such centers including its domestic markets, foreign investor markets and overseas markets for domestic investors. In this section, a ranking by independent reviews of financial centers are presented showing Russia's standing. It then proceeds to discuss how international financial centers develop, what are some of the regulatory obstacles in the Russian context and how to tap underserved market segments. Finally, this section discusses alternative regulatory structures that have been successful and could be considered in Russia.*

a. Introduction

16. **In 2008 the Russian government announced its intention of developing Moscow into an international financial center.** There have been several fora and initiatives on this and related matters in the last few years and which have steadily pushed the agenda forward. The main ones include (a) the Moscow Financial Centre Task Force which includes seven project groups and is headed by Alexander Voloshin, (b) the Presidential Council for Financial Market Development, (c) the Development of the Finance and Banking Sector Group 10, Strategy 2020, and (d) the International Advisory Board for an International Financial Center in Russia (where, inter alia, Herman Gref, CEO, Sberbank and Vikram Pandit, CEO, CitiBank are involved). As well, key conferences have also promoted the agenda, including the Moscow International Financial Forum, the Financial Innovation Forum, and Moscow International Finance Week. The Russian Direct Investment Fund has also been used as a forum for discussing issues on investing in Russia as well as the financial center concept and issues.[1]

17. **The government's announced plan anticipated the following benefits:**

- Improving the access of Russian companies to funding;
- Providing better investment opportunities for institutional and private investors;
- Improving the integration of the Russian financial system with the global financial system;
- Boosting the role of the ruble as a reserve and settlement currency;
- Promoting economic integration with CIS countries; and
- Diversifying the national economy through the growth of the financial sector.

[1] World Bank technical advisory work since 2009 to present has touched on related financial sector issues in Russia including (a) a Financial Sector Memorandum discussing access to finance issues and financing mechanisms, (b) a technical piece on Bank Competition in Russia, (c) a report on Financial Consumer Protection and Financial Literacy, and (d) a report on the Funded and Private Pension System and its development.

18. This report examines Russia's and Moscow's current level of financial development, what the goals for the development of the city's and the country's financial sector should be, and how such goals might be achieved.

b. Clarifying the goals

19. **An international financial center is a jurisdiction in which the level of financial business far exceeds that justified by domestic economic activity alone.** Currently, the level of financial business in Moscow is not only not above such a level but far below it. This is because much of the financial business that arises from domestic economic activity is conducted abroad. Large enterprises seek most of their financing in the global financial centers; wealthy Russians hold much of their wealth abroad.[2] Figure 1 and Figure 2 show the extent to which Russian firms have sought ever more equity and debt financing from foreign sources in recent years.

Figure 1. Russia - Gross equity portfolio liabilities as a percentage of GDP[3]

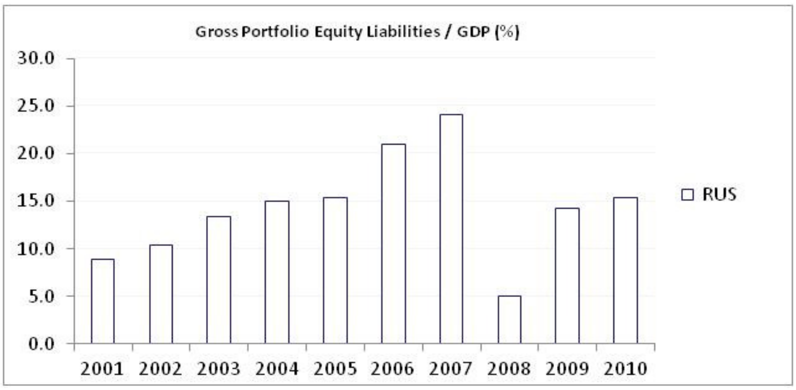
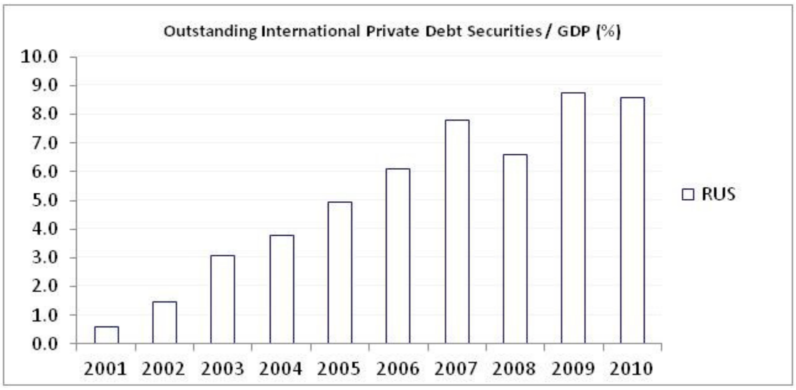


Figure 2. Russia - Outstanding international private debt securities
(Percentage of GDP[4]



2 In addition, government saving – a large part of national saving – is largely invested abroad. The Russian government held some US$524 billion in foreign exchange reserves in June, 2011.

3 World Bank, "FinStats", World Bank, 2011.

4 World Bank, "FinStats", World Bank, 2011.

20. **The situation of relying on foreign sources is typical of countries that do not themselves host an international financial center.** It is the situation, for example, in most of the countries of Western Europe. They rely on the global financial centers of London and New York for a substantial part of the financing of their large enterprises, and many wealthy Europeans hold part of their wealth in Switzerland and in various offshore centers. Indeed, the very existence of financial centers doing more than domestic financial business implies that the financial centers of other countries will be doing less. Moscow is therefore not unique in this respect, but it is an extreme case.

21. **The reliance on foreign financial centers is not a problem for the Russian economy: on the contrary, it is highly beneficial.** The domestic financial system is currently incapable of meeting the needs of the economy. "Importing" financial services in this way allows those needs to be met and thereby allows the economy to develop and grow. It facilitates foreign investment in the Russian economy. And, indeed, it facilitates Russian investment in the Russian economy. For example, private banks in Moscow offer their customers mutual funds in Luxembourg; these mutual funds invest heavily in Russian securities. The advantage of this arrangement is that it provides Russian investors with legal protection not available to them were they to invest directly in domestic securities or in domestic mutual funds. For the development of Moscow as a financial center, however, this is a reality that must be recognized, and doing so suggests that policy should be framed in terms of two goals:

(a) ***Rather than aiming to attract foreign financial business to Moscow, the immediate goal should be to compete for Russian financial business that is currently conducted abroad.*** This competition should be fair—unaided by restrictions that favor the local market.[5] The goal is to make Moscow a more attractive financial center, not to interfere with the economically beneficial use of global financial centers. Achieving this goal will require significant changes in the legal and regulatory environment.
Once Moscow becomes competitive as a center for Russian financial business, it will naturally attract foreign financial business as well, particularly from the CIS and Eastern Europe. For these countries, Moscow offers some advantages in terms of geographic proximity, specialized knowledge, language, and perhaps currency.

(b) ***While the present reliance on global financial centers addresses the financial needs of large enterprises and of the wealthy, it does not address the financial needs of SMEs and small investors.*** If Moscow, as a financial center, could find a way to address those needs, it would greatly benefit the development of the economy and the financial well-being of ordinary Russians. Moreover, as the report will indicate, it could be an important step in achieving the first goal – of attracting more Russian financial business back to Moscow.

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5 For example, the current regulations that limit foreign placements of new stock to 35 percent of the total and that require 30 percent to be issued domestically should be revoked. The government has expressed its intention of doing this (see ICLC, *Russian Survey*, August 2011).

Box 1. Russia and Moscow in terms of Country Comparators

How can one compare Russia, and particularly Moscow, to other financial centers around the world? It is easy to think of a list of the biggest centers – Hong Kong, London, New York and Singapore are famous for the access to capital and financial services they offer – but it is also useful see how Russia matches up against countries with similar economic characteristics or financial markets that are similarly small, yet satisfying the funding needs of their domestic firms and attracting business from their region.

There are two straightforward ways to make these comparisons. The World Bank has a financial sector comparison tool called "FinStats", which uses nine structural factors that are most relevant to financial sector growth in order to compare structurally similar countries to each other. One can use it to see how a country is performing relative to other countries, given the similarities in their starting points. The nine factors that Finstats looks at are

- GDP per capita;
- population size;
- population density;
- the dependency ratio of old people to working-age people;
- the dependency ratio of young people to working-age people;
- whether a country is an "offshore" financial center;
- the degree of exports accounted for by oil exports;
- whether a country is a "transition" country;
- and where the global economy is on its business cycle.

On these factors Russia should be compared to Brazil, China, Colombia, South Africa and Thailand. Throughout the text these are referred to as "comparator countries."

Box 2. Russia in terms of International Financial Center Comparators

But what about financial centers themselves? Alongside making comparisons between the financial sectors of different countries, use a variety of sources are used to see how MICEX, Russia's largest stock exchange, looks against exchanges around the world that are notable for either their regional or global significance. Where the data allows one can then see how the development of Russia's leading exchange fares against a variety of exchanges, each of which has important strengths. These are

- the Australian Stock Exchange (Sydney, Australia);
- BM&F Bovespa (Sao Paulo, Brazil);
- Deutsche Borse (Frankfurt, Germany);
- the Hong Kong Exchanges (Hong Kong, China);
- the London Stock Exchange (London, United Kingdom);
- the NASDAQ OMX Nordic Exchange (Scandinavia);
- NYSE Euronext (New York, United States); NYSE Euronext (Europe);
- the Shanghai Stock Exchange (Shanghai, China);
- the Tokyo Stock Exchange (Tokyo, Japan);
- the TSX Group (Toronto, Canada);
- and the Warsaw Stock Exchange (Warsaw, Poland).

In the text they are referred to as "leading financial centers."[6]

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[6] Where an exchange agglomerates data from trading floors in several different countries and is not represented in the data below as one entity, it is left out of a comparison . "NASDAQ OMX Nordic Exchange" includes the exchanges of Copenhagen,

22. **But first, to obtain an overall idea of where Russia and Moscow stand, one can use the "Global Financial Centres Index" (GFCI) as a means of comparison.** The GFCI measures financial centers as to their ability to provide factors such as a streamlined and transparent business environment, highly skilled local staff, a clear regulatory system and other factors that may attract financial firms to locate there or have effects on the viability of its financial markets. Some non financial factors than make a difference in the attractiveness of a city or country as a financial center include its overall macroeconomic environment and policies, efficient transportation facilities, reasonable housing availability and costs, as well as education facilities for foreign visitors and their families. Table 1 provides a ranking for Moscow against the main cities covered by the GFCI in the comparator countries. It comes at the bottom.

Table 1. How Moscow compares in the GFCI to financial centers in comparator countries[7]

City	GFCI ranking
Hong Kong	3
Shanghai	5
Beijing	17
Sao Paulo	44
Rio de Janeiro	50
Johannesburg	54
Bangkok	61
Moscow	*68*

23. With some overlap between the cities, Table 2 shows how Moscow ranks simply against the leading financial centers in the GFCI. Again, it comes out at the bottom.

Table 2. How Moscow compares in the GFCI to leading financial centers[8]

City	GFCI ranking
London	1
New York	2
Hong Kong	3
Shanghai	5
Tokyo	5
Sydney	10
Toronto	10
Frankfurt	14
Sao Paulo	44
Warsaw	59
Moscow	*68*

Helsinki, Iceland, Stockholm, Tallinn, Riga and Vilnius. "NYSE Euronext (US)" mainly includes the New York Stock Exchange and NYSE Arca. NYSE Euronext (Europe) includes the Amsterdam, Brussels, Lisbon and Paris exchanges.

7 Z/Yen and Long Finance, *The Global Financial Centres Index 9*, Z/Yen and Long Finance, March 2011.

8 Z/Yen and Long Finance, *The Global Financial Centres Index 9*, Z/Yen and Long Finance, March 2011.

24. **To obtain a broader picture of Russia's standing, one can also use Russia's rankings on the World Economic Forum's Global Competitiveness Index (GCI), which has a sub-index on financial market development.** On the sub-index it is ranked 125th out of 139 countries. The ranking is derived from an executive survey and some data from the World Bank's Doing Business report. The GCI rates Russia most highly on "affordability of financial services" (92nd) and lowest on "regulation of securities exchanges" (118th), "restriction on capital flows" (119th), and "soundness of banks (129th). Russia's performance against the comparator countries is shown in Table 3.

Table 3. How Russia compares on the GFCI rankings of financial market development vs. comparator countries[9]

Country	GCI rank (score out of 7) on financial market development
South Africa	9 (5.3)
Brazil	50 (4.4)
Thailand	51 (4.4)
China	57 (4.3)
Colombia	79 (4)
Russia	*125 (3.2)*

25. **Finally, the Milken Institute, a US think-tank, ranks the ease with which entrepreneurs and businesses can access domestic and foreign capital in 122 countries.** The ranking includes seven factors – the macroeconomic environment, the institutional environment, financial and banking institutions, equity market development, bond market development, the availability of alternative sources of capital, and the availability of international funding – to produce the Capital Access Index (CAI). In 2009 Russia ranked 54th out of 122 countries with rankings of 69 and 33 respectively on the importance of its equity and bond markets for business financing. Table 4 shows how it ranks against comparator countries.

Table 4. How Russia compares on the CAI to comparator countries[10]

Country	CAI rank (score out of 10)
Thailand	27 (6.51)
South Africa	31 (6.15)
China	32 (6)
Brazil	49 (5.14)
Colombia	53 (4.97)
Russia	*54 (4.96)*

9 World Economic Forum, *The Global Competitiveness Report 2010-2011*, World Economic Forum, 2010.
10 Milken Institute, *Capital Access Index 2009*, Milken Institute, 2010.

c. The Right Way to Achieve the Goals

26. **Financial centers are not created top-down: they develop organically wherever sufficient demand exists for their services.** An unsatisfied demand represents a profit opportunity. Entrepreneurs will exploit this by supplying the desired services. If a government attempts to create a financial center artificially – for example, by restricting access to other, existing financial centers – the result will be a net loss to the economy. The gains from the artificially created center will be more than offset by the higher cost or the inferior quality of the service that it provides.

27. **While a government cannot artificially create an economically viable financial center, it can remove obstacles to its natural development.** For example, some component usually found in a financial center may be missing – such as a market for long-term bonds. The appropriate question to ask is not "How can the government create a bond market?" But rather: "Why has this market not emerged naturally?" The answer may be, in the particular circumstances, that there is no demand for such a market or that the demand exists but is already satisfied elsewhere better than it could be satisfied locally. In such a case, nothing can or should be done. However, the answer may be that there are artificial obstacles to the local emergence of such a market. In this case the government can act to remove those obstacles.

28. **Even in the case of the government removing obstacles it is necessary to be realistic about how long it will take to achieve the desired results.** If the obstacle is some specific regulation or tax, then it can be removed relatively quickly. Even then, however, the response may be quite slow. If the obstacle is something like corruption or the absence of rule of law, removing it may take decades. Setting quantitative targets for the development of a financial center – for example, having a stock exchange in the world's top ten by 2020 – makes no sense at all. Setting such targets is more likely to result in pointless manipulation of the statistics than in any genuine progress.

d. What are the Obstacles?

29. **One major obstacle, common to all cities wishing to become financial centers, is the advantages of scale enjoyed by existing major financial centers.** The larger a financial center, the better the service it provides: Its markets are deeper and more liquid and it provides a richer array of services. These advantages of scale are self-reinforcing: since new business tends to be attracted to the largest center, the latter tends to grow still larger. Any emerging financial center must compete with centers that already exist. Because of the advantages of scale, it is initially at a significant disadvantage.

30. **If a new financial center is to emerge nonetheless, it must have some compensating advantages over larger, established centers in at least some areas.** Generally, these will be advantages of information and convenience – usually the result of geographic and cultural proximity. For example, Hong Kong and Singapore have an advantage, relative to London and

New York, in mediating financial business that involves China.[11] Moscow possesses a similar natural advantage with respect to financial businesses involving smaller enterprises and households within Russia itself and financial businesses involving members of the CIS.

31. **However, measures of how connected Russia and Moscow are to the rest of the world in terms of commerce suggest that they have some way to go in offering high levels of information and convenience.** On the AT Kearney/Foreign Policy Globalization Index, which measures the level of connectedness between one country and the rest of the world, Russia is 62nd out of 72 countries. In other words, Russia is not particularly well connected with the rest of the world.[12] Furthermore, the quality of life in Moscow is not regarded as higher than that found in many financial centers, despite the fact that it is one of the most expensive cities in the world to live in.[13]

32. **In addition to the natural obstacle of scale, Moscow faces several obstacles that are man-made – largely the consequence of government action or inaction.**[14] They are well known and may be divided into the following categories:

- An unpredictable and costly business environment: corruption, absence of the rule of law and frequent and arbitrary government intervention; an inefficient bureaucracy; an inefficient and unpredictable legal system.[15]
- Barriers to foreign entry: restrictions on the entry of foreign financial firms, on foreign ownership of Russian firms, on entry of foreign professionals.[16]
- Chaotic and complicated regulation: an excess of red tape; and inconsistent enforcement.
- Counter-productive tax laws: VAT on financial transactions and services, high tax rates on financial firms, excessive taxation of foreign residents, etc.

e. How to Overcome the Obstacles

33. **In overcoming these obstacles, there are some important general background principles to bear in mind: the key to overcoming the fundamental obstacle of scale is to tap the potential financial business in which Moscow has a comparative advantage – that of SMEs and households.** Because such business requires a great deal of local information and

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11 Jarvis, D. S. L. (2009). Race for the Money: International Financial Centers in Asia, Lee Kuan Yew School of Public Policy, National University of Singapore.

12 AT Kearney/Foreign Policy, "The Globalization Index," AT Kearney/Foreign Policy, 2007.

13 See Mercer, "2010 Quality of Living Survey," Mercer, 2010 and Mercer, "2011 Cost of Living Survey, Mercer, 2011.

14 The situation is not unique to Moscow. Tokyo, Paris, and Singapore, too, have been hindered from realizing their full potential as financial centers by government-created obstacles. (Elliott, D. J. (2011) Building a Global Financial Center in Shanghai: Observations from Other Centers. Washington, DC, Brookings Institute). However, once again, if Moscow is not unique, it is an extreme case.

15 For details, see World Bank, "Doing Business in the Russian Federation", World Bank, 2011.

16 There was some relaxation of visa regulations for "highly skilled workers" in December 2010 (Fitzgeorge-Parker L., "Russian Capital Markets: Climate Change", Euromoney, May 2011). However, entry remains difficult.

retail distribution, these are not functions that could be performed directly by other global financial centers.

34. **Channeling the funding needs of SMEs and households into the market could increase the supply of securities.** Similarly, finding ways to satisfy the investment needs of small investors could increase the demand. Although each borrower or investor is small, the aggregate is potentially large. In the United States, for example, SMEs and households, in aggregate, account for most of the business of the financial markets. Households and non-profit enterprises in the U.S. accounted for US$ 49 trillion or 76 percent of financial asset holdings at end-2011 versus corporate businesses (excluding financial sector) that held $15 trillion.

35. **SMEs do not, however, have direct access to financial markets. Such access is always indirect – through a variety of financial intermediaries.** Similarly, while small investors can invest in securities directly themselves, they mostly do so through financial intermediaries. Therefore the key to bringing the business of SMEs and small investors to the financial markets is the development of financial intermediaries. Table 5 shows the current number, assets and percentage of total assets of the main sectors of financial institutions, including financial intermediaries in Russia.

Table 5. Financial Intermediaries in Russia[17]

	2010		
	Assets (RUB, bn)	% of total assets	Number
Credit institutions	33,805	93.8	1,012
State-owned banks	13,871	38.5	21
Private banks			
Domestic	13,717	38.1	844
Foreign	6.084	16.9	90
Nonbank credit institutions	132	0.4	57
Nonbank financial institutions	2,241	6.2	
Unit investment funds (PIF)	420	1.2	796
Private pension funds	862	2.4	158
Insurance companies (premiums)	960	2.7	*700*
Total	36,046	100	

36. **Increasing the scale of Russia's financial businesses in this way would increase the liquidity and the depth of the Russian market.** This would make it more competitive with global financial centers for the business of large Russian enterprises and wealthy Russian

[17] Sources: IMF, Central Bank of Russia, FFMS, Expert RA. The figures exclude leasing companies. These held some RUB 1,050 billion in assets at the end of 2010; factoring companies held an additional RUB484 billion (See Economist Intelligence Unit, *Country Finance Russia*, Economist Intelligence Unit, 2011). "Foreign banks" means banks that are majority foreign-owned.

investors, as well as for financial businesses from the CIS. This would, of course, further increase the scale of business in a virtuous circle.

37. **Poland provides an example of the above process. Reforms have created a dynamic system of financial intermediaries – banks, pension funds, and investment funds.** As a result, small investors and their intermediaries now account for over half the turnover on the Warsaw Stock Exchange. The growing size of the market has increasingly attracted listings from other East European countries, making Warsaw an emerging regional financial center.[18] However, some characteristics of the Polish case need be mentioned as particular enabling factors. These include a major initial and continuing program of privatizations, currently a high level of foreign bank ownership, a critical mass of domestic (and sub-regional) listed securities market with liquidity to attract outside investors, and a respectable and improving cost of doing business ranking.

38. **In Russia, by contrast, the financial intermediaries that could connect SMEs and small investors with securities markets are seriously underdeveloped.** In 2010, the assets of all financial intermediaries added up to only 81 percent of GDP, compared with over 300 percent in France, Spain, and Germany. Moreover, in Russia, banks make up some 94 percent of the total. Non-bank financial intermediaries such as investment companies (mutual funds), pension funds, and insurance companies are particularly poorly developed (see Table 5). In more developed financial systems, they typically hold a majority of total assets.[19] This report will examine in detail why financial intermediaries are so underdeveloped and why they therefore fail to contribute to the growth of financial markets. The report will also examine the weaknesses of the financial markets themselves. But first some general comments on regulation and on the legal environment are warranted.

f. Principles of Regulation

39. **With respect to regulation, there is a tendency to focus on its form rather than on its substance.**[20] Beautifully crafted laws are of little value if they are not enforced, or even if they are enforced and fail to achieve their objectives. Imposing extensive reporting requirements gives the appearance of doing something about a problem but may achieve little. Moreover, red tape increases transactions costs and may thereby price a financial service or even a financial center out of the market (the Sarbanes-Oxley Act in the Unites States is a case in point). More regulation is not necessarily better regulation. Certainly, some new regulations will be required. However, it is no less important to remove existing regulations that achieve little and raise costs while standing in the way of financial development. Regulation should be simple and consistent and should pass an elementary cost-benefit test.

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18 Financial Times, "Warsaw as a Financial Centre", FT Special Report, Financial times, April 20 2011.

19 In the US, non-bank financial institutions hold about 60% of total assets. In Poland in 2007 they already held about one third of total assets (see National Bank of Poland, "Financial System Development in Poland 2007," National Bank of Poland, 2010).

20 Ahrend, R. and W. Tompson (2005). Fifteen Years of Economic Reform in Russia: What has been Achieved? What Remains to be Done? OECD Economics Department Working Papers, No. 430, OECD Publishing.

40. **Often, the best way of achieving this is self-regulation.** Market professionals have a far better understanding of the issues than government bureaucrats and legislative committees. They are better placed to weigh the costs imposed by a regulation against its benefits. And they have a strong reputational interest in its effectiveness. Placing regulation in the hands of self-regulated organizations (SROs) has another important benefit: by removing power from the hands of government bureaucrats it reduces the potential for corruption. However, SROs need to have incentives to maintain high standards and a reputation for the market – if these elements are not in place, a self regulatory structure could simply be used as a market capture mechanism by dominant players.

g. How to Provide a Satisfactory Legal Environment

41. **There are a number of approaches to dealing with the deficiencies in the legal environment (both in the law itself and in its enforcement by State courts).** One is to export the activity to a different jurisdiction: An example of this is seen in the practice of wealthy Russians placing savings in Cyprus or investing in Russian securities through mutual funds located in Luxembourg. Because the securities are held in Luxembourg, any disputes are resolved in Luxembourg courts according to Luxembourg laws.

42. **Another approach is to import the legal environment.** This is the approach being taken by Dubai in its attempt to become a regional financial center:

> The Dubai International Financial Centre is an independent jurisdiction under the UAE Constitution, and has its own independent civil and commercial laws, which are written in English and which default to English law. It also has its own courts, with judges taken from the common law world including England, Singapore and Hong Kong.[21]

43. **Importing a legal environment can be an important and effective tool.** However, since Russia has already been developing a domestic market and given the size of its economy, it is important that this tool, if used to attract foreign investors, be done so in conjunction with – rather than as a substitute for – additional measures to deepen, improve and innovate within the domestic capital market regulatory framework.

44. **Yet another approach as implied above, is to rely as much as possible on arbitration administered by self-regulatory organizations (SROs).** Arbitration is less formal and consequently both faster and less expensive than reliance on formal courts of law. In this, too, Dubai provides an example.[22] Another example is the Novo Mercado in Brazil where as an SRO, the securities exchange imposes corporate governance requirements, beyond those required by law, if firms wish to be listed on the exchange. By using some combination of these approaches,

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[21] See http://en.wikipedia.org/wiki/Dubai_International_Financial_Centre; http://www.difc.ae/

[22] "The DIFC-LCIA Arbitration Centre is an independent centre of international arbitration that uses rules modeled on the London Centre of International Arbitration." Source as in previous footnote.

it would be possible to provide the financial center with the legal environment it needs without having to wait for a general reform of the legal structure of the entire country – something that is likely to take a considerable amount of time. The government seems to envision a similar shortcut in the real sector, in its plans for a high-technology center at Skolkovo.[23]

45. **These alternative models of regulation are important because on many measures of the legal environment and its close cousin, the business environment, in Russia it suggests that there are serious problems that need to be solved.** On the World Bank's Doing Business measure Russia ranks 120th out of 183 countries.[24] On the World Economic Forum's index of the economic competitiveness of 144 countries Russia ranks 66th.[25] Finally, on the Economist Intelligence Unit's ranking of business environments – which looks at factors such as the political and macroeconomic environments and policies towards free enterprise and trade – Russia's business environment is considered to be "moderate", or 62nd out of 82 countries.[26]

46. **On specific measures, such as those for governance, transparency and corruption, Russia as a whole performs poorly.** For example, on Transparency International's Corruption Perceptions Index it verges on being considered highly corrupt.[27] PriceWaterhouseCoopers, which publishes an analysis of economic crime across the world, recently found that Russian respondents to their survey were more likely to report having experienced fraud in the preceding 12 months than respondents from any other country.[28]

47. **To support the development of Moscow as an international financial center, the legal and regulatory framework will need to require, at a minimum, that all market participants (banks, non-bank financial institutions and securities market intermediaries) disclose their beneficial owners.** These beneficial owners need to be subject to economic, fiscal, fit-and-proper, and criminal tests, as well as conflict of interest verification, and asset disclosure tests on an initial and continuing basis as a condition to obtain or hold a license to operate on the market. Failure to disclose beneficial owners, or failure of beneficial owners to pass these tests should lead to denial, suspension or revocation of license by the financial sector regulators.

48. **Relying as much as possible on the knowledge and experience of market professionals, it would be desirable to set up private sector working groups to identify the important obstacles in different areas of financial development as a guide to government**

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23 See Freeland C, "The Next Russian Revolution", *The Atlantic*, October, 2011.

24 World Bank Group, *Doing Business 2012*, World Bank Group, 2011.

25 World Economic Forum, *The Global Competitiveness Report 2011-2012*, World Economic Forum, 2011.

26 Economist Intelligence Unit, "Country Monitor," vol XVIII, no 48, Economist Intelligence Unit, December 27th 2010.

27 Transparency International, "Corruption Perceptions Index 2010," Transparency International, 2010.

28 PriceWaterhouseCoopers, *The Global Economic Crime Survey: Economic Crime in a Downturn*, PriceWaterhouseCoopers, 2009.

action. Singapore has done this with considerable success.[29] It has set up working groups in seven specific areas.[30] Doing so signaled the government's receptiveness to input from the industry and led to effective specific reforms and liberalizations. In Russia, the existing Working Group on Establishment of an International Finance Centre could set up groups of market professionals to advise it on needed reforms in specific areas. Or a new working group with high private sector participation could be set up. The report now examines in turn, banking, non-bank financial intermediaries, and financial markets.

Part II. The Special Role of Banks in Supporting Major Financial Centers

49. *Section Synopsis: This section discusses banks' role in the foundations of capital markets. It evaluates the current state role in banking in Russia and recent developments, as well as the potential function of private banks and foreign banks in the financial system. The small and medium enterprise and household sectors are reviewed in terms of their access to financial services and the state of competition in the banking sector. The expansion of bank branch networks for household deposit collection is addressed as well as a discussion of other current and potential sources for bank funding.*

a. Banking

50. **Plans to develop Moscow into a financial center have largely focused on financial/capital markets. But banks and other financial intermediaries are no less important to the development of a financial center.** In addition to their own role in serving borrowers and investors, they are potentially a major source of supply of securities and of demand for securities in the financial market. In Russia, the overwhelming majority of financial intermediation is accounted for by banks (see table 5). The report now examines the current state of the banking system. It then turns to how it might be restructured and the benefits to be expected from such a restructuring.

51. **Recent work on banking has largely, and – given recent events – perhaps naturally, focused on stability.** While this is undoubtedly of great importance, of more direct concern to this report is "function" – what banks actually do. Do they do what one would expect of a modern banking system, and, in particular, do they contribute as much as they could to the development of Moscow as a financial center?

29 Barton, D. (2009). International financial centres: the terms of competition and prospects for the Asia-Pacific region. Competition among financial centres in Asia-Pacific : prospects, benefits, risks, and policy challenges. Soogil Young and others. Singapore, Institute of Southeast Asian Studies: lxiv, 399 p.

30 General debt issuance, equity markets, fund management, treasury/risk management, corporate finance/VC, insurance/reinsurance, and cross-border electronic banking.

Banking in Russia Today

52. **The banking system is dominated by state-controlled banks.** In 2010, the state controlled some 40 banks – some directly (as in table 5) and others indirectly through other state-controlled entities including other state banks. Together, these state-controlled banks held about 54 percent of total bank assets.[31] Table 6 shows the ten largest banks in Russia, whether state-owned, private, domestic or foreign. The top six are controlled by the state.

53. **The state's presence has increased steadily since 1998: in each subsequent crisis, preferential state support for state banks has made them a safe haven for depositors and has enabled them to take over weaker private banks.**[32] The share of state-controlled banks is far higher than in other transition economies, which have gone much further in privatizing their banking systems.[33] While some of Russia's largest commercially oriented state banks operate using international standards, there are others with special mandates where governance arrangements and operational and accounting transparency could be much improved to assess their overall risk.

Table 6. Ten largest banks in Russia- total assets, December 2010[34]

Bank	**Total loans**	**Total assets**	**Market share (%)**
Sberbank	4,993	8,888	23.6
VTB	950	2,732	7.3
Gazprombank	815	1,812	4.8
Rosselkhozbank	594	1,070	2.8
Bank of Moscow	427	923	2.5
VTB 24	419	923	2.5
Alfa Bank	395	851	2.3
UniCredit	344	679	1.8
Raiffeisenbank	262	505	1.3
Promsvyazbank	182	490	1.3
Total assets		**37,590**	**100**

54. **In the planned economy of the Soviet Union, a major role of the banks was to prop up loss-making enterprises by providing them overdraft loans that allowed them to pay their bills.**[35] There is some suspicion that this practice has not entirely died out.[36] In any event, state-controlled banks continue to be more an instrument of government policy than purely

31 Vernikov, A. (2011). Government banking in russia: magnitude and new features, Higher School of Economics.

32 Berglof, E. and A. Lehmann (2009). "Sustaining Russia's growth: The role of financial reform." Journal of Comparative Economics 37(2): 198-206.

33 Of 20 countries assessed by the EBRD and IMF in 2008, Russia vas in the bottom half for bank liberalization, Berglof, 2009, Ibid.

34 Economist Intelligence Unit, *Country Finance Russia*, Economist Intelligence Unit, 2011. The private banks are in italics.

35 The loans were not expected to be repaid. Their purpose was to prevent a domino effect on the loss-making firm's suppliers.

36 Bernstam, M. S. and A. Rabushka (2004). Fixing China's Banks, Not Russia's, Hoover Institution.

profit-seeking commercial institutions. A large number of private banks, most of them very small, account for about 28 percent of total bank assets. Many are "pocket banks," owned by and primarily serving a single company or a financial industrial group.[37] Many others exist only to provide their owners with tax advantages or to facilitate money laundering.[38] So the role of the private banks in purely commercial financial intermediation is modest.[39]

55. **Foreign banks account for about 18 percent of total bank assets (and 12 percent of deposits).**[40] This share is much smaller than in other transition economies where privatization has often led to the domination of the banking system by foreign banks.[41] The market share of foreign banks in Russia grew slowly between 2000 and 2010, but has declined in recent months: several major foreign banks have quit Russia altogether (including Rabobank, AIG, and Santander), and others have closed their retail banking operations (including Morgan Stanley, Barclays, and HSBC).[42] Much of the lending of foreign banks consists of working capital loans to large oil and metals enterprises or to subsidiaries of foreign multinationals.[43]

56. **Overall therefore, purely commercial lending by banks to Russian enterprises to which they are not connected is in some way quite limited.** For large enterprises, this is not a problem since they are, in general, connected. Moreover, as large enterprises have borrowed increasingly from banks in the global financial centers and from the international bond markets this enables them to borrow larger sums, for longer periods, and on better terms.[44] Smaller enterprises, however, find it hard to obtain loans from Russian banks: loans to SMEs, in particular, make up only about 6 percent of total bank assets.[45]

57. **Consumers, too, are poorly served by the banking system.** The level of penetration of banking services is quite low compared to other countries. There is only one bank branch for every 40,000 Russians, for example, compared to one per 1,000-3,000 inhabitants for developed economies, and one per roughly 10,000 for other transition economies and Brazil.[46] Because of

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[37] Financial industrial groups are the groups of related companies that produce over 50 percent of Russian GDP. Those owned and controlled by the federal government produce about 25 percent; regional governments, 4 percent; and private groups 21 percent. See http://www.emergingmarketsvenue.com/2010/07/12/russian_business_groups/

[38] Camara, M. K. and F. Montes-Negret (2006). Deposit Insurance and Banking Reform In Russia. Policy Research Working Paper 4056, The World Bank.

[39] Bonin, J., I. Hasan and P. Wachtel (2008). Banking in transition countries, BOFIT Discussion Papers.

[40] Anzoategui, D., M. S. M. Pería and M. Melecky (2010). Banking Sector Competition in Russia. Policy Research Working Paper 5449, The World Bank.

[41] Part of the reason for this has been restrictions of foreign ownership of banks in Russia. However, some of these restrictions may be lifted with Russia's likely accession to the World Trade Organization (WTO) (see Clover C, "Russia to Cut Tariffs Ahead of WTO Entry," *Financial Times*, 11th November 2011.

[42] Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

[43] Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

[44] Tompson, W. (2004). Banking Reform in Russia: Problems and Prospects. Economics Department Working Papers No. 410, OECD.

[45] Loans outstanding to SMEs were about RUB2 trillion in May, 2011 (see Central Bank of Russia, "Bulletin of Banking Statistics", Central Bank of Russia, July 2011).

[46] Camara, Montes-Negret, op. cit.

this poor access, and of a general lack of faith in financial institutions, bank deposits of individuals add up to only about 26 percent of GDP, compared to 47 percent in Hungary and 80 percent in the Czech Republic. Fewer than one in four of the population have bank accounts; personal checks are virtually unknown; and most household savings are still held in the state-owned savings bank, Sberbank, or in cash.[47] Lending to households, however, did increase rapidly is the period before the 2008 crisis – particularly for housing; this fueled a bubble in housing prices, especially in Moscow.[48]

Box 3. Russia and Moscow in international comparisons of banking systems

Compared to its peers in countries with similar economic fundamentals – Brazil, China, Colombia, Thailand and South Africa – the Russian banking system is home to relatively fewer deposits, and issues less private credit. Interestingly, between 2000 and 2009 the Chinese system maintained much higher levels of both, as shown by figures 3a and 3b.

Figure 3a. Domestic bank deposits as a % of GDP[49]

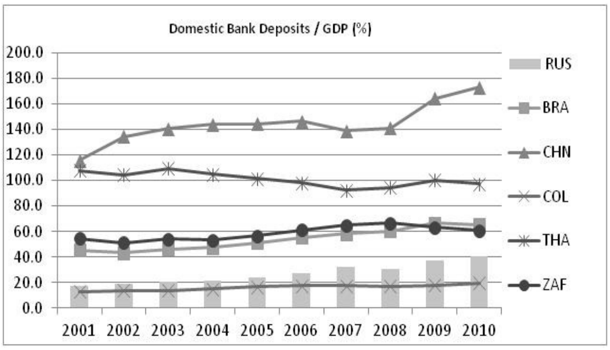
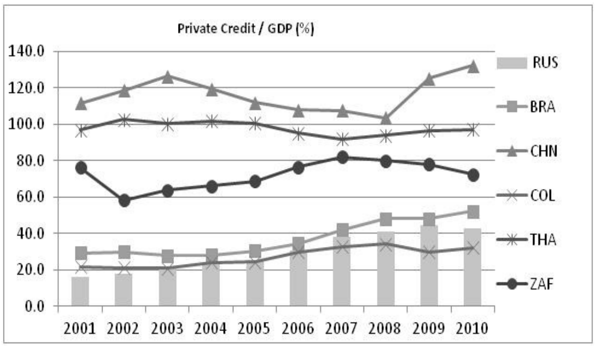


Figure 3b. Private credit to GDP[50]



b. The Need for Restructuring

58. **Thus a large part of the potential for the banking system – accepting deposits from households and lending to SMEs – goes largely unexploited.** The reason for this is a lack of competition. Banks that enjoy an easy life because of their market power are unlikely to make the considerable efforts necessary to tap this unexploited business. The lack of competition is itself the result of state dominance of banking, and of barriers to the entry of foreign banks.

59. **Banks, like financial centers, enjoy significant advantages of scale.** A large bank can be better diversified, should enjoy better liquidity, and can divide fixed costs over a larger volume of business; it should also be able to offer a wider range of services. In Russia, the large banks are mostly state banks. In addition to the usual advantages of scale, they also enjoy preferential treatment by the state.

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47 Bonin, Hasan andWachtel; Economist Intelligence Unit, *Country Finance: Russia*, EIU, 2011.

48 OECD, *Economic Survey of the Russian Federation*, OECD, 2009.

49 World Bank, "FinStats", World Bank, 2011.

50 World Bank, "FinStats", World Bank, 2011.

60. **Allowing private banks to start up does not threaten the dominance and market power of the state banks, since such new banks are necessarily small.** Only the entry by other large banks is capable of increasing competitive pressure. And the only way for large banks to enter is from abroad. Entry and expansion of foreign banks is limited by a variety of regulations. The most important of these limit the ability of foreign banks to purchase existing domestic banks – an important way for them to enter the market and to expand their presence.[51] Moreover, purchase by foreign banks is a natural way to bring about the much-needed consolidation of the myriad private banks into fewer, larger, and more robust institutions.

61. **Free competition requires not only unimpeded entry but also a level playing field. The preferential treatment of state banks makes it hard for others to compete.** The foreign banks that have recently been quitting the Russian market have complained about the expansion of state-owned banks, especially Sberbank and VTB, into additional lines of business, such as corporate, retail, and investment banking.[52] The government seems to realize that the continued dominance of banking by the state is not consistent with its goal of making Moscow an international financial center. It has recently announced plans for a new wave of part-privatization of state-owned enterprises, including state-owned banks.[53] This is, of course, to be welcomed. However, it is essential that this privatization be genuine and not merely cosmetic. Selling a minority stake in the major state banks to private investors will achieve little if these banks continue to enjoy a privileged position and to serve as instruments of state policy.

c. The Benefits of Increased Competition in Banking

62. **Increased competition in banking would force banks to seek new deposits by expanding their branch networks and by soliciting the business of ordinary households.** It would also give them a strong incentive to increase their lending to SMEs.[54] This would probably mean a further expansion of leasing, which is already growing quite fast.[55] Banks need to find longer-term sources of funds. Current law allows the withdrawal of all household deposits on demand, regardless of the contractual terms.[56] This makes it hard for banks to fund longer-term loans with deposits.

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51 Any investor requires permission from the RCB to purchase more than 20% of any bank; purchases of over 25 percent also require approval from the Federal Anti-Monopoly Service (FAS) (see Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011).

52 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

53 Aris B, "Russia Kicks Off Privatization Effort with Sale of 10 percent in VTB," *Russia and India Report*, Mar. 2, 2011.

54 World Bank, "Russia Financial Sector Memorandum: Expanding Finance for Small and Medium-Sized Enterprises—What can be done?", World Bank, December, 2010.

55 USAID, "Leasing: A Potential Solution for SME Expansion and Rural Financial Sector Deepening," microNOTE no.23, USAID, June 2006. At the end of 2010, total leases amounted to about RUB1 trillion (see Economist Intelligence Unit, *Country Finance Russia*, Economist Intelligence Unit, 2011).

56 OECD, *Economic Survey of the Russian Federation*, OECD, 2009.

63. **One alternative is long-term bonds, and banks have indeed been increasing their bond issues in recent years.** In May 2011, some RUB218 billion of 1-3 year bonds were outstanding, together with RUB354 billion of longer-maturity bonds.[57] A natural development, especially to finance an increasing volume of leasing, would be the issuance of covered bonds.[58] This would also be a way to fund ruble-denominated mortgages for households. The latter would provide a much safer alternative to the current reliance on foreign-currency mortgages funded by bank borrowing from foreign banks. In any event, the increased issuance of bonds would provide additional business for the capital market, helping to develop Moscow as a financial center.

Part III. The Function of Non-bank Financial Intermediaries

64. *Section Synopsis: This part of the report reviews the function of non-banks as well as the role of retail investors in capital market demand. It discusses investment funds and asset management companies including the link between banks and asset management firms. It then reviews the funded pension sector, its structure and development, and the need for expanding investable instruments and consideration of certain tax issues. The section then addresses the insurance sector and its role, past governance and practices in the industry, the need for enhancing the industry's professional skills, and barriers to entry in the business.*

a. Securities brokers, funds and other non-bank institutions

65. **A significant demand for securities on the part of small investors can make an important contribution to the development of a financial center.** As seen, while some small investors do access markets directly, most do so through non-bank financial intermediaries such as investment funds, pension funds, and life insurance companies. Unfortunately, such non-bank financial intermediaries are particularly poorly developed in Russia – together accounting for only about 6 percent of the total assets of all financial intermediaries (Table 5).

66. **The main obstacle is public distrust of financial institutions – largely justified by experience.** Non-bank financial institutions have a poor record in Russia, with many having failed or proven to be fraudulent.[59] And the sector fared particularly poorly during the recent financial crisis.[60] Consequently, households largely prefer to invest in real estate and in foreign

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57 Bulletin of Banking Statistics, July, 2011. Banks accounted for about 36% of the total amount of bonds issued in 2010; they were also big investors in bonds (see Economist Intelligence Unit, *Country Finance Russia*, Economist Intelligence Unit, 2011).

58 These are bonds backed by specific cash flows (from leases for example), but still remaining as general obligations of the issuer. They are popular in Europe, and have a particularly long history in Germany as *Pfandbriefe.* There is very little issuance of asset-backed bonds at the moment (see Economist Intelligence Unit, *Country Finance Russia*, Economist Intelligence Unit, 2011).

59 Aris B, "Russia's Ponzi Problems", *BNE*, August 2011.

60 Http://rt.com/programs/money/russia-financial-sector-development/

currency.[61] The weakness of the sector is also partly a result of unfavorable demographics. In most countries, long-term saving by households is largely motivated by provision for retirement. In Russia, a relatively low life expectancy reduces the incentive for such saving.

b. Investment Funds

67. **Most investment funds in Russia are unit investment funds – a pool of assets held under a trust management agreement between investors and an asset management company (AMC).** In terms of redemption, the fund may be "open-end", "closed-end", or an "interval" type.[62] Interval funds fall between open-end and closed-end funds. They are open-ended but shares can only be purchased/sold during certain dates during the year. The industry grew quite fast between 2001 and 2008. In 2001 there were some 51 funds (35 AMCs) with a total of RUB10 billion in assets and only a few thousand investors. By 2008 there were 1,047 funds (over 300 AMCs), with RUB649 billion in assets and over 300,000 investors.

68. **This rapid growth was largely the result of favorable macroeconomic conditions, which raised returns; and of enabling legislation.** The Investment Fund Law was passed in 2001, together with secondary legislation regulating the investment activities of the investment funds, related asset management companies, and the special depositories that held the funds' assets. Improvements and clarification of the taxation of different types of investment funds also helped. In addition, both the number of licensed AMCs and the assets of investment funds grew rapidly as a result of the pension reform in 2002. However, in 2009, as a result of the financial crisis, assets dropped to RUB370 billion and the number of funds to 796; there was a slight recovery in 2010.[63]

69. **Suggestions for further development of the industry generally focus on tighter regulation and on strengthened enforcement as a way to improve the safety of the funds and to reassure investors.**[64] But this is not the right approach. The reason investment funds in developed economies do not suffer from the same problems is not because regulation is tighter there. Rather, it is because AMCs have a strong reputational interest in gaining and keeping the confidence of investors. Unlike in Russia, AMCs in developed economies are relatively few and large.

70. **The best way to reach such a state of affairs in Russia is through the development of a competitive banking system.** Bank branches would provide an ideal channel for marketing funds – as they do in many countries (Germany, for example). And banks would have a

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61 Sherstnev, M. A., D. V. Abramov and S. A. Polezhaev (2010). "Moscow as international financial center: ideas, plans and perspectives." EJournal of Corporate Finance 2: 27-35.

62 Noel, M., Z. Kantur, E. Krasnov and S. Rutledge (2006). Development of Capital Markets and Institutional Investors in Russia: Recent Achievements and Policy Challenges Ahead. World Bank Working Paper No. 87. Washington DC, The World Bank.

63 Ibid; Alexei Goriaev, "Mutual Funds: research project proposal," 2007/2008.

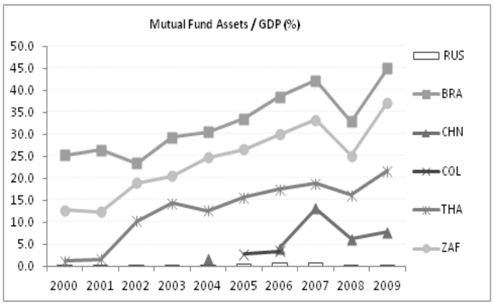
64 For example, Ibid.

reputational incentive to market only those funds that were safe and that provided good service – either their own or those of other reputable AMCs.

Box 4. Russia and Moscow in International Comparisons of the Investment Funds Industry

Figure 4 shows the extent to which one part of the Russian investment funds industry – mutual funds – has failed to grow at a rate similar to that found in the comparator countries. In recent years there has been reasonably consistent growth in Brazil, China, South Africa and Thailand.

Figure 4: Mutual fund assets as a % of GDP[65]



c. Pension Funds

71. **The pension reform that began in 2002 replaced the existing PAYGO state pension system with a three-pillar system modeled on that of Sweden.** The first pillar is a reduced, basic PAYGO pension; the second pillar is a mandatory defined-contribution plan; and the third pillar is a voluntary, supplementary, defined-contribution plan. The second and third pillars created new opportunities for private-sector asset managers and pension plans.[66] The second pillar is managed by the Pension Fund of Russia (PFR), which collects the contributions. A contributor has three options with respect to his/her account balance: (a) to leave it with the PFR, which then invests it in a fund managed by the state development bank, Vnesheconombank (VEB); (b) to leave it with the PFR, but request that it be managed by an approved private asset manager; (c) to transfer it to an approved non-state pension fund (NSPF).

72. **By the end of 2009, some 50 million contributors had enrolled, and their account balances totaled some RUB570 billion.** Approximately 85 percent of contributors had their accounts with VEB, approximately 10 percent with asset managers and 5 percent with non-state pension funds. In terms of assets, 84 percent, 3 percent, and 13 percent were managed by VEB, asset managers, and NSPFs, respectively.[67] By late 2005, third-pillar plans had enrolled some 6 million contributors. By the end of 2009, account balances had grown to some RUB669

65 World Bank, "FinStats", World Bank, 2011.

66 Ibid.; and Rudolph, H. P. and P. Holtzer (2010). Challenges of the Mandatory Funded Pension System in the Russian Federation, Private and Financial Sector Development, Europe and Central Asia Region, The World Bank.

67 Rudolph and Holtzer, Ibid.

billion.[68] Almost all of these plans were sponsored by employers, since there is a large tax penalty for contributions not made through an employer.

73. **There are restrictions on the asset allocation of pillar-2 funds.** Any fraction may be invested in state bonds, up to 40 percent in sub-sovereign bonds, and small amounts in corporate bonds and stocks (the limits have gradually been increased). Until late 2009, VEB had to invest exclusively in state bonds. Since then it has been allowed some investment in other assets. At the end of 2010, NSPFs had 30 percent of their assets in bank deposits, 30 percent in claims on other financial institutions (mainly investment funds), and about 20 percent each in government and corporate bonds and in shares.[69]

74. **Despite the significant development of private pension funds since 2002, much of their potential contribution to the development of the capital market remains untapped.** Most of the pillar-2 funds remain in the hands of PFR/VEB. Most of the pillar-3 funds are from the plans of large companies where the sponsors reinvest some 30 percent of the assets in the company itself.[70] A retail market that serves individuals directly, is largely absent. In the developed economies and even in other transition economies such as Poland, Slovakia, Lithuania, Croatia and Bulgaria, such individual plans are a major source of funds for the capital market. The development of a retail market also requires tax changes to remove the current tax disadvantages of individual retirement savings. It also requires a supply of investment vehicles that are safe and that offer a reasonable return.

75. **If the banking and investment-fund sectors were to develop along the lines suggested, they would provide such vehicles and market them vigorously as a matter of course.** As well, if the bond markets (including the sovereign bond market) developing more issuances on the longer term segment of the yield curve as discussed further below, this would assist pension funds in holding assets that more closely match the maturity and payments of pension obligations.

d. Insurance Companies

76. **In the developed economies, life insurance companies are important financial intermediaries, channeling household savings into the capital market.** Many forms of life insurance – for example "whole life" – combine pure life insurance with an element of savings in various ways. This generates a large pool of funds which life insurance companies can invest long-term. Property-liability (non-life) insurers are also financial intermediaries. However, their policies do not contain any element of savings, and they also have a greater need for liquidity: they are consequently less important as long-term institutional investors.

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68 Total NSPF assets were RUB743 billion (IMF). Of these some RUB74 billion were pillar-two funds, Ibid.

69 Bank of Russia Pension Fund Balance Sheet, 2010.

70 Noel, Kantur, Krasnov and Rutledge, Op. cit.

77. **The insurance industry is quite small in Russia and life insurance is virtually non-existent.** In 2010, total assets were some RUB960 billion – life insurance was less than 2 percent of this (compared to a world average of around 50 percent).[71] There were, nonetheless, some 700 insurance companies. An increase in required minimum capital in 2012 is expected to reduce that number considerably. Insurance is sold directly to companies and through a system of agents to households.

78. **The insurance industry has a poor history in Russia.** The 1990s saw a great deal of instability and a large number of failures and frauds. Moreover, until a tightening of the tax laws in 2007, much of the subsequent activity in the industry – particularly in life insurance – was not insurance at all but rather transactions undertaken to avoid taxes and to disguise flows of money. For example, the OECD estimated that in 2003 only 30 of the largest 100 life insurance companies were actually involved in true life insurance; only two of these were selling policies to individuals.[72] With the tightening of the tax laws, life insurance premiums collapsed. They have since slowly begun to recover, helped by the growing practice of requiring life insurance for mortgage borrowers.

79. **The growth of the industry, particularly of life insurance, to a more normal size depends on regaining the trust of the public.** Trust is especially important for life insurance because it involves long-term commitments. There are two factors that can potentially increase trust – size and foreign ownership. Size matters because of reputational economies of scale: a large firm stands to suffer much greater losses from actions that harm its reputation. Foreign ownership helps for a similar reason: the Russian operations of a foreign insurance company might be small, but its global operations are usually large. Since reputation is indivisible, problems with its Russian business would reduce faith in the company worldwide.

80. **There remain significant barriers to the entry and operation of foreign insurers**. These should be removed.[73] Free entry will increase competition in the industry, leading to consolidation into larger domestic insurance companies. The industry also suffers from a shortage of specialized professionals – especially in the actuarial profession, the accounting and auditing professions, and in insurance law.[74] This shortage could be alleviated by removing the obstacles to the entry of foreign professionals in these areas.

81. **The final obstacle to the growth of the industry is limited marketing channels – particularly to households.** Currently, life insurance has to rely on an unsatisfactory system of

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71 IMF and World Bank, "Insurance Sector Development and the Insurance Core Principles," FSAP Update, IMF and World Bank, 2008.

72 Mariska MD and Manson TB, "Reforming the Insurance Market in Russia" Policy Issues in Insurance No. 10, OECD, 2005.

73 IMF and World Bank, "Insurance Sector Development and the Insurance Core Principles", FSAP Update, IMF and World Bank, 2008.

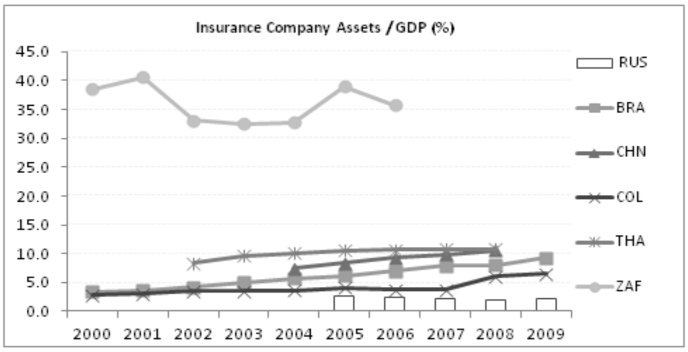
74 IMF and World Bank, "Insurance Sector Development and the Insurance Core Principles", FSAP Update, IMF and World Bank, 2008.

independent insurance agents.[75] Development of a competitive banking sector with extensive branch systems would provide an effective solution. The sale of insurance by banks, "bankassurance", is widespread in western Europe. This would also, of course, address the trust issue, since the reputation of a bank would be harmed by selling insurance products that proved defective.

Box 5. Russia and Moscow in international comparisons of the insurance industry

The small size of Russia's insurance industry is stark when put against comparator countries. As a percentage of GDP it lags behind countries such as Colombia and Brazil and appears to be a long way behind countries such as South Africa.

Figure 5. Insurance company assets as a percentage of GDP[76]



Part IV. Private Banking and Private Equity Markets

82. *Section Synopsis: This section addresses the role of private banking and private equity institutions and investments. It discusses the potential of the private banking market for channeling Russian investor wealth into the capital markets. In the private equity realm, initiatives in venture capital are reviewed as well as the option of private partnership forms to develop this market, and the current role of the state within this market segment.*

a. Private Banking and Hedge Funds

83. **The wealthy have always been a major source of funds for the capital market.** Russia possesses a significant wealthy class: its combined assets in 2010 were estimated as being on the order of RUB10 trillion; some 101 Russians were listed on Forbes's list of the world's billionaires.[77] Private banks exist to manage the assets of the wealthy. As seen, however, private

75 Mariska MD and Manson TB, "Reforming the Insurance Market in Russia" Policy Issues in Insurance No. 10, OECD, 2005.
76 World Bank, "FinStats", World Bank, 2011.
77 Sherstnev, Abramov and Polezhaev, "The Next Russian Revolution", *The Atlantic*, October, 2011.

banks – even those in Moscow – invest their customers' funds abroad. However, as also seen, some of these funds return to Russia as a part of foreign institutional investment.

84. **Hedge funds are another investment vehicle for the wealthy (and for institutions), and they play an important role in capital markets.** Hedge funds were expected to be authorized in Russia in 2008 for qualified (wealthy) investors. However, most of the assets of hedge funds active in Russian securities – serving both foreigners and Russians holding their wealth abroad – were expected to remain in the hands of hedge funds located outside Russia.[78]

b. Private Equity

85. **Private equity can be an important component of a capital market.** In particular, exits from private equity can be a major source of IPOs and of new listings of smaller companies for exchanges like NASDAQ. Private equity is particularly sensitive to the quality of the business environment so there has been little activity in this area. Russia has attracted only US$ 1.4 billion in foreign private equity over the last three years, compared to US$ 15 billion for India and US$ 5 billion for Brazil (neither of which has an exemplary business environment).[79] Domestic private-sector private equity is tiny: in 2010 there were some 80 venture capital funds registered, but only 25 were conducting deals, and some of these outside Russia.[80] Other forms of private equity, such as leveraged buy-out (LBO) funds and expansion funds, seem to be completely absent.

86. **Of course, the business environment is not an obstacle for the state itself.** As a result, what activity there is in private equity is almost entirely undertaken by the government or in partnership with it. In 2006, the government established the Russian Venture Company (RVC) as a sort of fund of funds. In 2007, it set up Rosnano to finance high-technology initiatives.[81] And in March 2011 it announced a US$ 10 billion private equity fund in partnership with foreign investors.[82] The government also plans to invest some US$ 6.6 billion in a new high-technology incubator at Skolkovo, which it is hoped will eventually house some 15,000 scientists and entrepreneurs.[83]

87. **One legal impediment to private equity is the lack of a suitable organizational form.** Most private equity funds abroad are organized as limited partnerships. This framework is not available in Russia, and private equity funds have to use the same legal framework as that employed by closed-end investment funds. In August, 2011, however, the government introduced new legislation in the State Duma that would create "investment partnerships" and

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78 RosBusinessConsulting,"Hedge Funds to get Green Light in Russia", RosBusinessConsulting

79 Chassany A-S, Corcoran J, "Russia: Still the Wild West for Private Equity", *Business Week*, April 28 2011.

80 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

81 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

82 Chassany A-S, Corcoran J, "Russia: Still the Wild West for Private Equity", *Business Week*, April 28 2011.

83 "The Next Russian Revolution", *The Atlantic*, October, 2011, Op. cit.

"economic partnerships" – frameworks that bear some similarity to the limited partnership.[84] Even so, the government is likely to have the field of private equity largely to itself for some time to come. This is unfortunate, because governments do not generally have a particularly good record as private equity investors.[85]

Part V. The Capital Markets: Depth, Function, Liquidity and Innovation

88. *Section Synopsis: This section addresses a comprehensive range of capital market issues and its sub-segments. It starts with the composition and structure of the market and the recent initiative on merging the securities exchanges. It reviews the IOSCO-based regulatory and supervisory standards in Russia. It then discusses the equity markets and the constraints in the pricing of companies. The characteristics of company ownership and control in Russia are discussed with implications for pricing signals. Following that, the role of market mergers and takeovers is reviewed as well as the role of the over-the-counter market, and the function of depositary receipts, and company start-ups. Russia's standing versus capital markets in comparator countries is analyzed as well. The discussion then proceeds to the role of the derivatives, government debt and the private bond markets, and the linkages to accounting norms and the function of credit agencies. The issues of asset securitization including legal and regulatory constraints are also discussed. The section then addresses the development of the money markets and the role of the foreign exchange markets. Finally, regulatory strategy issues are raised including self-regulatory structures, back-office functions, securities registration, treatment of collateral, beneficial ownership and disclosure issues. Insider trading is addressed and its regulatory approach analyzed, as well as the topic of investor protection, the role of financial reporting, and specific issues surrounding securities listing requirements.*

89. **The report now will address the financial markets themselves. It will examine the institutional structure of financial markets, the markets for equities, debt, forex and derivatives, and financial market regulation.** As seen throughout the financial system, the same issue applies to the financial/capital markets: those making use of the financial markets are predominantly and to an unusual degree, a few very large companies (in energy, minerals, banking, and communications);[86] and both the elements of market structure and the users of financial markets are largely owned or controlled by the state or connected to it.[87]

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84 ICLC, *Russian Survey No. 3*, ICLC, August 2011, http://www.iclcgroup.com/russian-survey.

85 Lerner, J. (2009). Boulevard of broken dreams: why public efforts to boost entrepreneurship and venture capital have failed--and what to do about it. Princeton, Princeton University Press.

86 Some ten issuers account for 80 percent of the market, Sherstnev, Op. cit.

87 Kuznetsov, A., O. Kuznetsova and Y. Mirkin (March 2011). The Russian Capital Market: The First 20 Years. Lancashire Business School Working Paper Volume 2, Number 3, University of Central Lancashire.

Structure of the Market

90. **Some sixty exchanges are licensed, of which half a dozen are actually operating.**[88] The largest exchange is MICEX, which accounts for 90 percent of organized trading in securities; RTS accounts for most of the rest. MICEX began as a currency exchange and then expanded into government securities, corporate bonds, and equities. It is owned by a group of the largest banks – most of them state-owned (including the Central Bank of Russia). RTS began as an OTC market and developed into an exchange. It is owned by a group of the larger broker-dealers. Table 7 shows the distribution, between 2005 and 2009, of securities between MICEX and RTS.

Table 7: Total number of securities listed at year end[89]

Exchange	2006	2007	2008	2009	2010
MICEX SE					
Total number of listed securities	221	387	485	450	541
Debt securities	156	264	341	317	386
Short-term paper	0	0	0	11	1
Bonds	156	264	341	306	385
Equity	65	96	144	133	145
RTS					
Total number of listed securities	412	598	531	501	465
Debt securities	4	152	129	94	61
Bonds	4	152	129	94	61
Equity	408	446	402	407	361
Other					43

91. **In February 2011, the two major exchanges announced a merger, to be completed by 2013.**[90] The government was instrumental in bringing the merger about, and state-controlled banks will hold a majority interest in the new, merged exchange (although the government has indicated that the Central Bank will be selling its stake).[91] The merger will result in a unification and simplification of regulations and procedures, in an improvement in the efficiency of trading platforms and of clearing and settlement, and in some improvement in market liquidity (though only modestly because the two exchanges largely trade different instruments).[92] Concern has been expressed about the resulting reduction in domestic competition, which has in the past been a driver of innovation, especially in the introduction of new products. However, the more important competition with the global financial centers will remain.

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88 See Noel, Kantur, Krasnov, Rutledge, Op cit., for a detailed description.

89 Bank for International Settlements, *Statistics on Payment and Settlement Systems in the CPSS Countries*, Bank for International Settlements, 2011, p 271.

90 For details, see "Stock Markets Integration", September 2011, available at http://www.exchange-integration.ru/en/

91 *The Trade News*, "RTS-MICEX Merger will Streamline Foreign Access to Russia", February 10 2011.

92 FOW, "Country focus: A New Dawn for Russian Derivatives?", *FOW*, September 2 2011.

92. **The market infrastructure, that is, the trading systems and the systems for clearing and settlement; is quite advanced technologically, but it is highly fragmented.**[93] This fragmentation significantly increases transaction costs – one reason why much of the trading of Russia-related instruments currently takes place in global centers.[94] The MICEX-RTS merger will consolidate infrastructure, with a corresponding reduction in transaction costs, making domestic financial markets more competitive vis-à-vis global centers, for Russian business.[95] Unfortunately, the merger will not improve the situation with respect to the registration of the ownership of securities. The system as it stands is cumbersome and slow, and an obstacle to efficient settlement.[96] There is some resistance on the part of companies to rationalization, since the current system can be manipulated by existing owners to resist a hostile takeover.[97]

93. **There are well over a thousand securities firms (broker-dealers and/or investment banks), but most of them are quite small.**[98] The twenty largest are all domestic; many of these are the subsidiaries of the large state-controlled banks. Sberbank recently purchased Troika Dialog, the largest independent securities firm; and VTB Capital has emerged as the dominant player in investment banking. As seen in Table 8, the banks dwarf any other sector in terms of the number of participants on MICEX and RTS. Most of the important international securities firms have a presence in Moscow, but none are among the top twenty.[99]

Table 8. Number of participants in Russia's exchanges and trading systems[100]

Exchange	2006	2007	2008	2009	2010
MICEX					
Total number of participants	341	349	296	300	346
banks	261	268	257	267	273
Other	79	80	38	32	72
Number of foreign participants	0	0		0	0
MICEX SE					
Total number of participants	555	633	669	654	649
Banks	319	347	355	350	363
Other	236	286	313	303	285
Number of foreign participants	0	0	0	0	0
RTS					
Total number of participants	188	245	251	227	231
Banks	65	87	93	87	90
Other	123	158	158	140	141
Number of foreign participants	0	0	0	0	0

93 For details see Noel, Kantur, Krasnov and Rutledge, p40 et seq., op. cit.

94 IMF and World Bank, "Financial Sector Assessment: Russian Federation", IMF and World Bank, 2008

95 See "Stock Markets Integration" reference above.

96 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

97 "The long road to an international financial centre," February 21, 2011, *RT.com*, http://rt.com/business/news/moscow-international-financial-centre

98 Noel, Kantur, p. 48, Op cit.

99 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

100 Bank for International Settlements, Statistics on Payment and Settlement Systems in the CPSS Countries, Bank for International Settlements, 2011. A "participant" is defined in the statistics as "…a legal entity that can submit (buy and sell) orders to the trading system on its own behalf or on behalf of its customers." A domestic rather than foreign participant is defined as "Any participant that is located in the country of incorporation of the trading system…".

Box 6. The IOSCO view of Russia's securities regulation

In April 2011 the International Monetary Fund (IMF) and the World Bank completed an assessment of Russia's implementation of the principles for securities regulation, as recommended by the International Organization of Securities Commissions (IOSCO).[101] The principles are designed to guide the development of a country's regulation of its securities market and for progress to be measured against ideal standards.

In the assessment the IMF found improvements in the powers of the regulator, but said that this could undermined if the respective roles of the Federal Financial Markets Service (FFMS) and the Ministry of Finance were not clarified soon. It also found that the FFMS was seeking power to be able to make market participants belong to a SRO and that this would be a positive development as membership is currently voluntary and only one third of participants belong to a SRO.

The IMF and World Bank declared they were satisfied with the new laws on market abuse and insider trading, but declared that they still needed to be tested. On information sharing it was argued that the FFMS had made progress in the ways that it and other government bodies communicated over regulation but that there were still some improvements to be made.

Regulatory vigilance in enforcing new rules on company ownership disclosures was emphasized, as was the need to maintain surveillance of the evolution of products in the market for collective investment schemes. The importance of strong oversight was also stressed for the introduction of new capital requirements, and pending rules over the appointment of provisional administrators for distressed firms and requirements that market participants engage in risk management.

Finally, it was noted that the FFMS had recently become able to conduct "real time" surveillance of the securities market, but that it would need to develop its experience in spotting and reporting suspicious behavior. It also remarked on the need for the FFMS to look again at listing and admission to trading procedures, as well as other infrastructure issues, in order to improve price reporting. Overall, on the 30 IOSCO principles, the report gave Russia a rating of "partially" or "broadly" implemented for 24 of them.

a. The Equities Market

94. To understand the Russian equities market, it is important to understand in general, what is the function of the equity markets.

95. **Equities markets normally play only a modest role in mobilizing funds for investment.**[102] Because of the problem of corporate governance, investors require a high expected return to provide equity financing, making it an expensive source of funds. As a result, companies finance most of their investment out of internal funds and the remainder largely with debt. Startups and rapidly growing companies are an exception: they lack sufficient internal funds and they may have difficulty borrowing, so the equity financing may be their only alternative. However, such companies cannot usually access public equities markets directly; they rely instead on private equity.

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101 International Monetary Fund, *Assessment of Implementation of the IOSCO Objectives and Principles of Securities Regulation*, International Monetary Fund, 2011.

102 Kohn, M. (2003). Financial Institutions and Markets, 2nd Edition. New York, Oxford University Press. Ch. 11.

96. **Equities markets are, rather, primarily markets for ownership.**[103] Markets for "industrials" first became important in the late nineteenth century in the U.K. and in the U.S. to facilitate and to finance the consolidation of industries, and they continue to play an important role in mergers, acquisitions, and restructurings. In continental Europe, equities markets became important only in recent decades, largely as a vehicle for the privatization of state-owned enterprises. Equities markets can play an important role in corporate governance by facilitating hostile takeovers (changes of ownership) of poorly-managed companies. And public equities markets can offer private equity an avenue of exit through IPOs, freeing up capital for new investments. Equities markets also enable existing owners to divest themselves of part of their stake in a company, thereby providing them with liquidity.

97. **As markets for ownership, equities markets necessarily perform an important informational function in pricing the shares of different companies.** Most trading takes place in response to new information about a company's performance and prospects – including potential changes of ownership. Such trading ensures that the market price of a company's shares embodies all of the relevant information. The market price is, among other factors, an indicator of how well managers are performing – a signal for, on the one hand executive bonuses and, on the other, for hostile takeovers.

The Circumstances in Russia

98. **The Russian equities market differs from equities markets in the English-speaking common law countries which the foregoing description conforms to most closely.** It differs in that it is dominated by a relatively small number of large companies. It also differs in the pattern of ownership. In the English-speaking common law countries, ownership is highly dispersed, with individuals rarely owning more than a few percent of total shares. In Russia, ownership and control are highly concentrated – often in the hands of the state or of those closely connected with it: concentrated owners typically hold something like 60-65 percent of total shares. The equities markets of continental Europe also exhibit a greater concentration of ownership, but Russia is an extreme case.

99. **These differences have a number of implications. Because the free float is small – estimates range from 5-35 percent of a company's total shares – the Russian equities market is much less a market for ownership**. It thus plays a much smaller role in mergers, acquisitions, and restructurings.[104] Since it is impossible to assemble a controlling stake through purchases in the open market, market-mediated hostile takeovers are impossible. Similarly, the potential role of the equities market in privatization is limited, since the sale of shares by the state will generally not imply its relinquishing control.

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103 Ibid, Ch. 15.

104 The true proportion is difficult to estimate because there is no legal definition of beneficial ownership and, therefore, no ability to measure accurately indirect ownership by controlling shareholders (See IMF and World Bank, "Financial Sector Assessment: Russian Federation", IMF and World Bank, 2008).

100. **It has been seen that private equity is not well developed in Russia and that what exists is largely an initiative of the state.** Consequently, startups and expansions have little access to the equities market as a source of financing for investment. Since market-traded shares do not provide control, their value should be lower than that of shares exchanged outside the market in large blocks that represent an element of control. The equities market serves mainly as a source of liquidity for the concentrated owners – a way of cashing out some of their investment, without giving up control.

101. **Another way in which the Russian equities market differs from those of the English-speaking common law countries, is that the disclosure of information by Russian companies is rather limited.** This lack of transparency means that share prices, particularly of companies in energy and minerals – which account for the bulk of trading volume – are likely to be moved by news about commodity prices rather than by news about the companies themselves. Consequently, foreign institutional investors may see these shares primarily as commodity plays.

Listing and Market Capitalization

102. **Total market capitalization of listed companies grew rapidly from US$ 124 billion equivalent (36 percent of GDP) in 2002 to peak at US$ 1,503 billion (116 percent of GDP) in 2007.** It then plummeted in 2008 as a result of the financial crisis and subsequently recovered to about US$ 1,000 billion equivalent (68 percent of GDP) in 2010.[105] The largest companies are generally listed in the equities markets of the global financial centers in the form of ADRs, global depository receipts (GDRs), and special purpose vehicles (SPVs). However, the listing of small issuers is inhibited by the plethora of steps that such issuers have to go through, plus the fact that, unlike in other markets, they often have to register their prospectuses.

103. **The rapid growth in market capitalization was mostly the result of price appreciation, but also – since early 2005 – of a sharp increase in the number of listings.** The number increased from 215 in 2004 to 345 in 2010.[106] This increase is partly the result of new regulations that require Russian companies to place at least 30 percent of any new stock issues in local markets and that impose a 35 percent limit on total foreign placements.[107]

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105 See http://www.indexmundi.com/facts/russia/market-capitalization-of-listed-companies. The total does not include listed closed-end investment funds.

106 See http://www.indexmundi.com/facts/russia/market-capitalization-of-listed-companies.

107 Financial Sector Assessment: Russian Federation, November 2008, IMF and World Bank. The new regulations were a response to a shift of trading volume from the domestic exchanges to the global exchanges: the share of the former fell from some 60 percent in 2003 to 30 percent in 2004 (Noel, Kantur). The head of the FFMS recently announced that this rule is unlikely to be lifted until 2013 (see Amos H, "Setback for Firms Listing Abroad," *The Moscow Times*, 11th November 2011

Box 7. Russia in International Comparisons of Listings and Market Capitalization

On the number of companies listed on its stock markets, Russia lags its country peers. As figure 7 shows, China has relentlessly added more listed companies to its exchanges over recent years. Russia's market did grow at the end of the 2000s, but it remains behind every comparator country except Colombia. Similar results are shown in Figure **7** for MICEX alone. It has the lowest number of listed companies when compared to leading exchanges around the world.

Figure 6. Number of listed companies
Russia versus comparator countries[108]

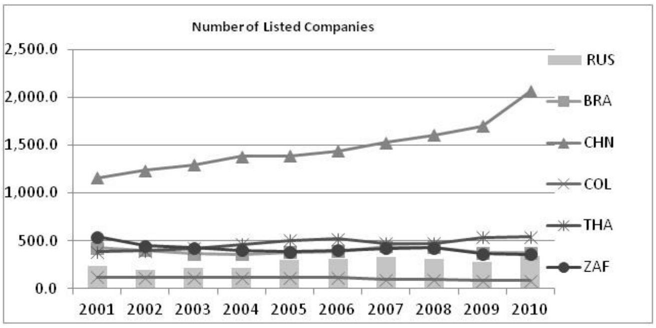
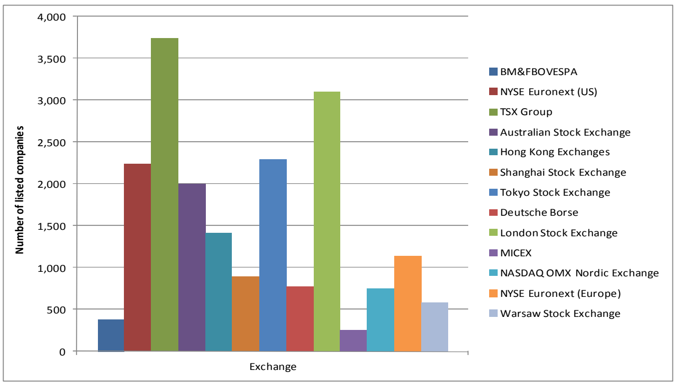


Figure 7. Number of listed companies
MICEX compared to leading exchanges, 2010[109]



Note: Bars from left to right correspond to legend names from top to bottom.

104. **As for the capitalization of Russia's stock markets as a percentage of GDP, Russia tracked the growth of its country peers during the 2000s.** By 2009 its comparative standing was similar to that of Brazil, Colombia and Thailand but behind China and a long way from the percentage achieved by South Africa, as shown by Figure 8. Compared to leading exchanges around the world, Figure 9 reveals that MICEX is smaller than each one except Warsaw.

108 World Bank, "FinStats", World Bank, 2011.

109 World Federation of Exchanges, 2011. The data on the London Stock Exchange is from end-2008.

Figure 8. Stock market capitalization as a % of GDP
Russia compared to its country peers 2000-2010[110]

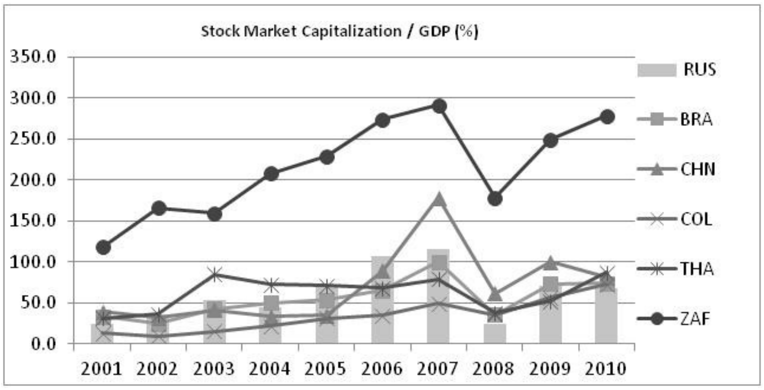
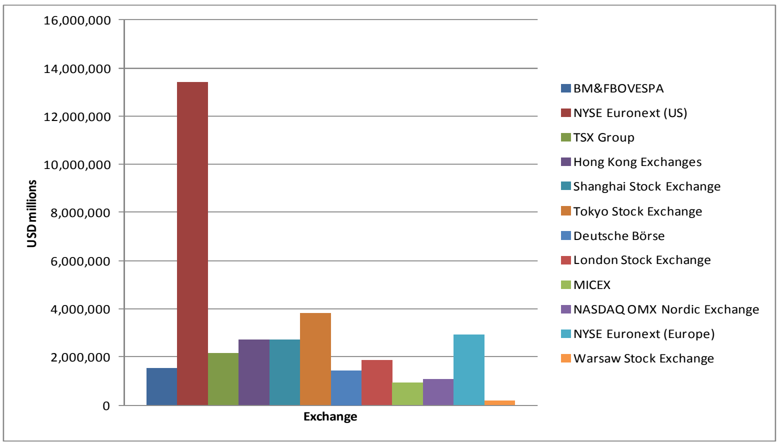


Figure 9. Stock market capitalization
MICEX compared to leading financial centers, 2010[111]



Note: Bars from left to right correspond to legend names from top to bottom.

105. **However, as would be expected from an economy with many companies in the extractive industries and a high degree of state involvement, Russia's stock markets show a large degree of market capitalization in a few firms.** Figure 10 reveals that only Colombia has a higher degree of capitalization concentrated in its ten largest listed companies among the comparator countries. The *declining* degree of concentration in China provides an example of a capital market attracting more firms to list and thus flattening the distribution of firm sizes across its exchanges. Again, the MICEX-specific data show the same story: in figure 11 it shows the highest degree of capitalization in its ten largest companies in comparisons with the world's leading global and regional exchanges.

110 World Bank, "FinStats", World Bank, 2011.
111 World Federation of Exchanges, 2011.

Figure 10. Market capitalization of the ten largest companies Russia compared to selected groups[112]

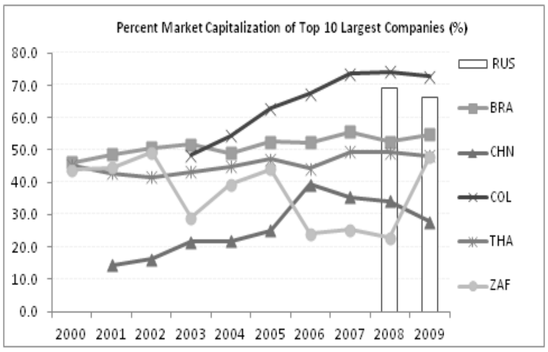
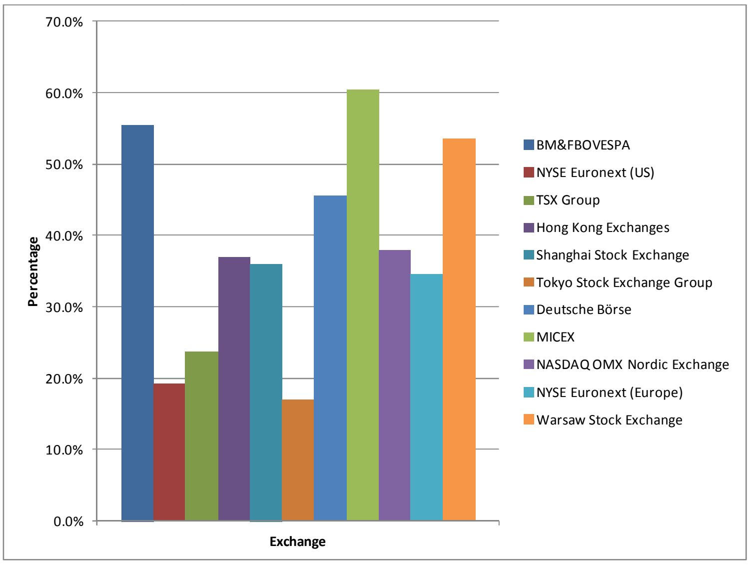


Figure 11. Market capitalization of the ten largest companies MICEX compared to leading exchanges, 2010[113]



Note: Bars from left to right correspond to legend names from top to bottom.

Trading Volume

106. **Turnover is relatively low, as it is in other emerging markets.** Annual trading volume fluctuated within the range of 35-65 percent of total market capitalization between 2002 and 2008, and rose to around 100 percent in 2009 and 2010.[114] The trading volume statistics are, however, problematic.[115] MICEX, which accounts for 90 percent of total trading, includes in its

112 World Bank, "FinStats", World Bank, 2011.

113 World Federation of Exchanges, 2011.

114 See http://www.indexmundi.com/facts/russia/market-capitalization-of-listed-companies.

115 IMF and World Bank, "Financial Sector Assessment: Russian Federation", IMF and World Bank, 2008

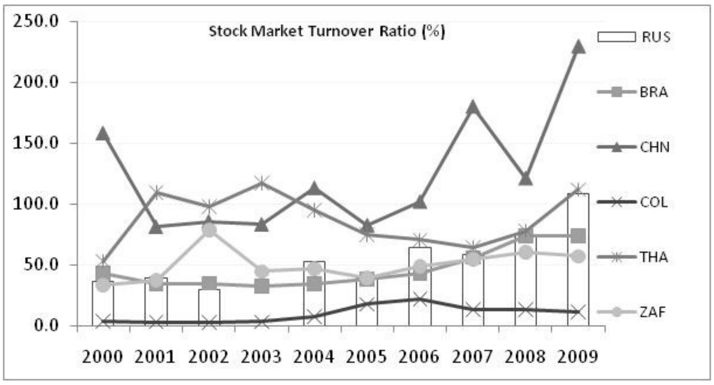
data the volume of equities repos.[116] These transactions are not really trades, in that they do not contribute to either liquidity or to price discovery. However, they may amount to as much as 50-60 percent of the reported total. On the other hand there is significant trading of stock in the OTC market: reporting for that is voluntary, so no hard data are collected. However, the volume of OTC trades may be as large, or larger, than that of trades on the exchanges.

107. **Most of the trading on the exchanges is concentrated in the stocks of the dozen largest companies.** Since the global markets are more liquid and have lower transaction costs, it seems plausible that they take the lead in price discovery and that much of the trading in Moscow represents arbitrage to close gaps between local prices and those in global markets. The stocks of the many smaller companies trade infrequently and are therefore relatively illiquid.

Russia in International Comparisons of Trading Volume

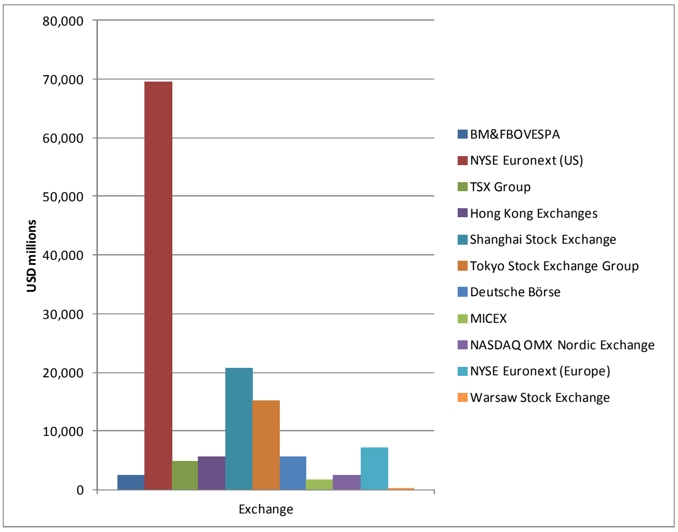
108. **As one would expect from a burgeoning market, China shows a much higher stock market turnover ratio than that of other comparator countries.** Russia, however, does not compare badly (although this may be because of the inclusion of equity repos data in the MICEX numbers, as discussed above). From 2006 it consistently matched Brazil, Thailand and South Africa on this measure of market depth. However, its leading exchange, MICEX, still compares poorly to the leading exchanges. It is only similar in scale to BM&FBOVESPA and the NASDAQ OMX Nordic Exchange and a long way behind other regional exchanges such as Toronto. Trading on MICEX is also highly concentrated in the stocks of the biggest companies (see Figures 12-14).

Figure 12. Stock market turnover ratio, Russia compared to country peers[117]



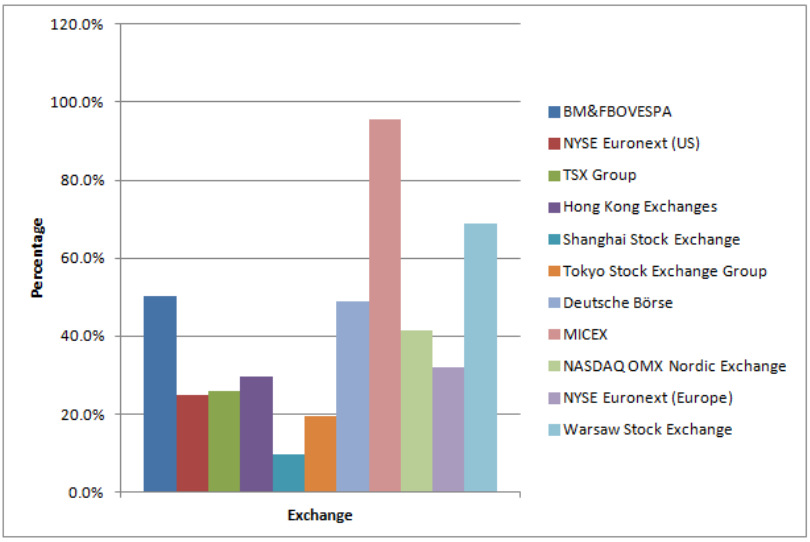
[116] A repo is a short-term money market loan collateralized with securities: formally, it is a sale of the securities and with a simultaneous agreement to repurchase at a later date at a pre-specified higher price.
[117] World Bank, "FinStats", World Bank, 2011.

Figure 12b. Value of average daily equity market turnover (US$ millions) MICEX compared to exchanges in financial centers, 2010[118]



Note: Bars from left to right correspond to legend names from top to bottom.

Figure 13. Percentage of total market turnover accounted for by turnover in the shares of the ten largest companies by market capitalization[119]



Note: Bars from left to right correspond to legend names from top to bottom.

The Over-the-Counter (OTC) market

109. **At least a part of OTC trading in Russia likely consists of transactions involving large blocks of shares that carry with them an element of control.** In such transactions, the price must be negotiated between the parties, and will depend on the particular circumstances

118 World Federation of Exchanges, 2011.

119 World Federation of Exchanges, 2011.

and terms of the deal. There are frequent suggestions to improve market transparency by requiring the reporting of all OTC trades. These suggestions fail to take into account the underlying reason for at least some of these transactions – concentrated ownership – or to recognize that the prices for control transactions will differ from those of ordinary transactions on the exchanges. Given this reality, ways would presumably be found to evade any new reporting requirement.

Supply and Demand

110. **As seen, the market is highly concentrated, with a small number of very large companies accounting for the bulk of market capitalization (in 2005, the 10 top stocks accounted for 76 percent).**[120] These large companies tend to float new issues on the global market rather than domestically, to the extent allowed by the law (and where they used to do so almost exclusively). On the other hand, a new law in 2009 allowed foreign companies to issue securities on Russian markets in the form of Russian Depository Receipts (RDRs). The few domestic offerings, mostly by smaller companies, are usually placed privately rather than being marketed to the public by underwriters.[121]

111. **A market for young innovative and growing companies (the IGC Sector) was established by MICEX in 2007 with the help of Rosnano.** RTS set up a similar market in the same year, "RTS START." However, each listed only a handful of companies in their first year.[122] One way to increase the flow of young and growing companies would be to simplify the issuance rules for small firms. However, as we have seen there is little in the way of private equity, which would have been the natural source of supply for new listings.

112. **A new and large potential source of offerings is the government's recently announced program of privatization.**[123] The government plans to divest completely from a number of "non-strategic" companies that it acquired during the recent crisis, and it plans to reduce its stake in many others while retaining control. The total amount to be sold through 2017 has been estimated at between US$ 40 billion and US$ 60 billion. Of course, much of this amount will be offered abroad on global markets.

113. **A major reason for the paucity of new offerings on the domestic equities market is the very limited demand.** The number of individuals trading equities directly is growing, but it remains small: the number registered at MICEX was just under 800,000 in October 2011 – almost double the number in 2007.[124] (This growth is partly the result of the increasing

120 Noel, Kantur, Op cit.

121 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

122 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

123 Filatova I, "Rosneft to Lead in $40bn Sell-Off", *The Moscow Times*, September 12 2011.

124 Popova N and Mauldin W, "Bread Line or Stock Sale", *Wall Street Journal*, October 26 2011. The article graphically describes the hardships of investors trying to sell their shares in a buyback at a company registrar. Regulations and red tape made the experience a protracted nightmare.

availability and popularity of online brokers.) As seen, institutional investors are not a major presence either: non-bank financial intermediaries such as investment funds, pension funds, and life insurance companies are very poorly developed.

114. **Foreign investors, institutional and individual, constitute the bulk of the demand.**[125] Altogether, foreigners held about a quarter of total market capitalization at the end of 2010.[126] This would have represented two thirds or more of the free float. Foreign investors might have held even more were it not for certain restrictions and obstacles: for example, a 2008 law limits foreign investment in "strategic sectors", including telecoms and mining.[127] Also, the arrangements for foreign investors to trade and to hold securities leave much to be desired. Foreign investors often have the generally preferable alternative of trading and holding Russian equities in global financial centers.

Equity-related Derivatives

115. **There is an active market in equity-related derivatives on the FORTS exchange (part of MICEX), on RTS, and on the EDX exchange in London (part of the LSE).**[128] Individual stock futures are largely traded on FORTS, options on EDX, and index futures on RTS. The two domestic derivatives exchanges will be merged as part of the merger of MICEX and RTS. Trading volume in derivatives has grown rapidly in recent years. This has been helped by a loosening of the restrictions on derivatives trading by pension funds and mutual funds. The restrictions should be eased further: for example, in the United States, it was the ability of pension funds to hedge their holdings with index futures that first brought them into the equities market in a big way.

b. Debt Markets

116. The report will now review in turn the market for government securities, the bond market, the market for asset-backed securities, and the money market.

Government securities

117. **The market for government securities plays a central role in any developed financial center.** The yield curve for government debt provides a benchmark – "the risk-free rate" – for pricing other, riskier securities. And government securities are the most convenient form of collateral for repo transactions and for margin in the derivatives markets. In Russia, it is difficult for government securities to play these roles because the market is so small and so illiquid. Because of high energy prices, the government budget has been in substantial surplus since 2000,

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125 Kuznetsov, Kuznetsova and Mirkin, Op cit.

126 Foreigners held US$231 billion of Russian equities at the end of 2010 (see Central Bank of Russian, "International Investment Position of Russia for 2000-2010: External Assets and Liabilities at End of Period," Central Bank of Russia, 2011)

127 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

128 FOW,"Analysis: New Technology, New Laws put Russia on Track for Growth", FOW, October 8 2011.

so that there has been little need to borrow. The amount of government debt outstanding at the end of 2010 was RUB 2.5 trillion, or only 6.2 percent of GDP.[129]

118. **Moreover, much of the outstanding debt is unavailable to the secondary market, because it is sequestered in the buy-and-hold portfolios of state-owned financial institutions.** These are principally the CBR, Sberbank, the Pension Fund of Russia (PFR) and the State Asset Management Company (GUK). Moreover, what little trading there is in the secondary market is fragmented, because of the large number of different types of instruments and the large number of different issues of each instrument. As a result, the secondary market is relatively illiquid.[130]

119. **Since 2004 the government has been trying to improve the quality of the market, inter alia, by shifting from foreign-currency debt in global markets to ruble-denominated debt at home.**[131] It has also attempted to increase the proportion of its domestic debt available to the secondary market – for example, by ending the CBR's purchases of government bonds in the primary market. In addition to the market for federal debt there is a considerably larger market for "sub-sovereign" government debt – for securities issued by regions and municipalities. The total amount outstanding was RUB 10.9 trillion at the end of 2010. The largest individual issuer is the City of Moscow, and the market for its debt is sufficiently liquid for it to be able to serve as a benchmark for the bond market.[132] A wide range of securities play the role of collateral for repos – from sub-sovereigns to equities.

120. **A recent World Bank study of the capital market, made a number of suggestions for improving the quality of the government securities market.**[133] However, even if these are implemented it is hard to see how the market for government securities could play the function it does elsewhere until the amounts outstanding increase significantly. This, of course, is a problem that many countries would actually like to have, i.e., low government debt. The government may wish, however, within its fiscal objectives, to consider a more active issuance of debt at key benchmark points in a yield curve allowing more liquid trading of such and thus generation of benchmark risk-free rates used to price other potential market securities.

The Bond Market

121. **The private bond market has grown rapidly, but it too remains quite small.** In July, 2010, the amount of bonds outstanding was RUB 2.7 trillion (US$84.5 billion). Russian

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129 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011; World Federation of Exchanges, "Fixed Income Survey," World Federation of Exchanges, 2010.
130 Noel, Kantur, Krasnov, Rutledge, Op cit.
131 Ibid.
132 Ibid.
133 Ibid.

companies also borrow in the global debt market: in July, 2010 they had outstanding some US$ 105 billion in Eurobonds and US$ 88 billion in syndicated loans.[134]

122. **There are differences between the sectors regarding the share of borrowing in domestic versus global markets.** Oil and gas companies conducted only 9 percent of their borrowing in the domestic bond market; banks, 29 percent; metals and mining, 41 percent, and transportation 71 percent. The remaining sectors borrowed 83 percent in the domestic market.[135] The largest issuers are in resource industries and banking—many of them owned directly or indirectly by the state ("quasi-sovereigns"). Although they did relatively little of their borrowing at home, they accounted for a large part of the domestic market.[136] Banks alone accounted for 36 percent of the total in 2010.[137]

123. **The banks are also major investors in bonds.** In 2002, they held 70 percent of the total, but by 2009 their share had declined to less than 40 percent.[138] Banks see the bond market as an outlet for surplus liquidity (in other financial systems, governments usually play this role). The best bonds can also be used to collateralize borrowing from the central bank (repo and other), for a very profitable carry. The proportion of the total held by institutional investors – insurance firms, non-state pension funds, investment funds – has been increasing. There is also increasing demand on the part of foreign institutional investors. Secondary trading takes place on MICEX and over the counter; in 2005, the OTC market accounted for about half of total turnover.[139] Trading almost exclusively comprises the debt of the few largest companies – almost all quasi-sovereigns. The market for bonds of smaller issuers is quite illiquid, which is typical of bond markets everywhere.

124. **Further expansion of the bond market is limited both by demand and by supply.** On the side of demand, non-bank financial intermediaries would constitute the natural market – both for public issues and for private placements. However, for reasons noted above, such intermediaries are seriously underdeveloped in Russia. On the side of supply, access to the bond market is limited for many potential issuers by inadequate credit information. There is something of a chicken and egg problem. Credit information is inadequate because companies fail to adhere to good accounting standards (IAS, for example). On the other hand, companies have little incentive to improve their accounting practices because there would not be much of a market for their bonds even if they were to do so. Similarly, there is not much in the way of

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134 Deutsche Bank, "Russia's Quasi-Sovereign Debt", Deutsche Bank Research, January 2011.

135 These numbers also are from Deutsche Bank Research. While syndicated loans are bank loans, they are long-term and often tradable, and are thus quite bond-like.

136 Fungáčová Z and Kurronen A, "Bonds Gaining Ground as a Finance Tool in Russia", Institute for Economies in Transition, Bank of Finland, January 2010.

137 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

138 Fungáčová Z and Kurronen A, "Bonds Gaining Ground as a Finance Tool in Russia", Institute for Economies in Transition, Bank of Finland, January 2010.

139 {Noel, Kantur, Op cit.

local credit rating agencies, because there is little potential business.[140] One reason for this is that the large companies that issue most of the securities are mainly quasi-sovereigns: their credit depends less on ratings than on the implicit guarantee of the state.

125. **Another factor limiting supply is the difficulty and cost of registration.** The process is unnecessarily complex and burdensome. There is also a tax on registration. Its level was lowered from 0.8 percent to 0.2 percent in 2005 and capped at about US$ 3,000.[141] The lowering of the tax contributed to the subsequent rapid expansion of the bond market.[142] Repealing the tax altogether would provide further stimulus, particularly for smaller issuers. There are also restrictions in the Civil Code on the amount of bonds a company can issue: such a limit would better be left to the market to assess.[143]

Russia in International Comparisons of the Bond Market

126. **Figure 14 reveals the extent to which the strong tax revenue from extraction of natural resources plus good fiscal management by the finance ministry in the past, has resulted in the government avoiding having to issue much debt over recent years.** In nearly all of the comparator countries, governments have been adding to their stock of domestic public debt. Figure 15 shows that these countries have been reducing their borrowing from international capital markets at the same time, but that Russia's withdrawal has been the most dramatic of the lot.

127. **In comparison, Figure 16 showing the amount of outstanding private international debt reveals the growing demand from Russian companies for funding from abroad.** However, Table 10 which shows the amount of money raised by new bonds on MICEX in 2008 and 2009, reveals that MICEX is not a laggard compared to several of the world's leading capital markets.

140 The largest local rating agency, Interfax, was purchased in 2004 by Moody's. There an independent agency, RusRating, that specializes in the banking sector. And there has been talk recently of the government setting up a new agency, together with other members of EurAsEC (See Bloomberg, "Russia Seeks to Loosen Rating Companies' Grip", Bloomberg, July 13 2011).

141 Noel, Kantur, Op cit.

142 Lowering the tax caused a shift to bonds from veksels (see below), which are not subject to the tax, Ibid.

143 Companies that issued "too much" debt would find the cost rising rapidly.

Figure 14. Outstanding domestic public debt securities as a % of GDP Russia versus comparator countries[144]

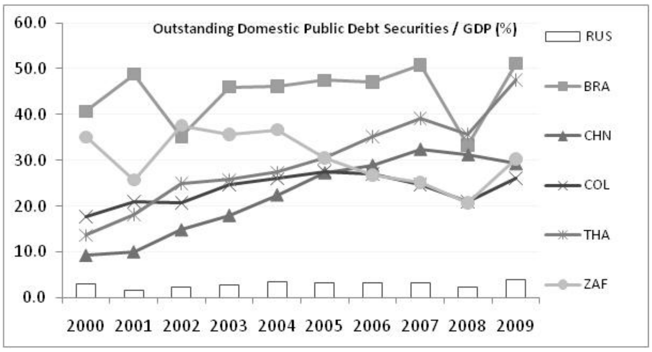


Figure 15. Outstanding international public debt securities as a % of GDP Russia versus comparator countries[145]

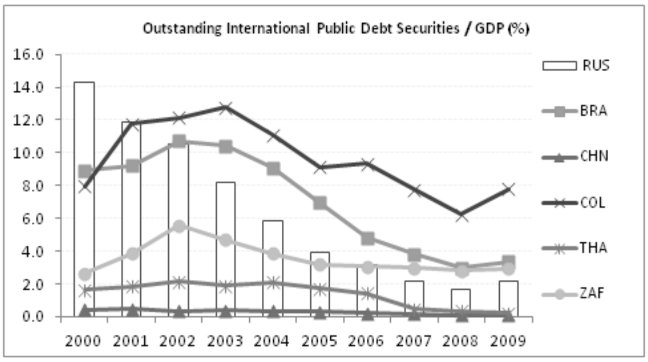
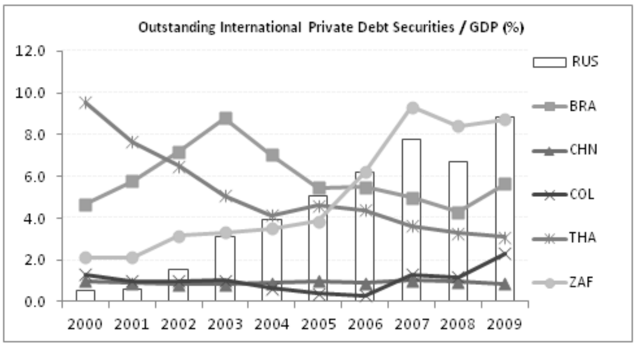
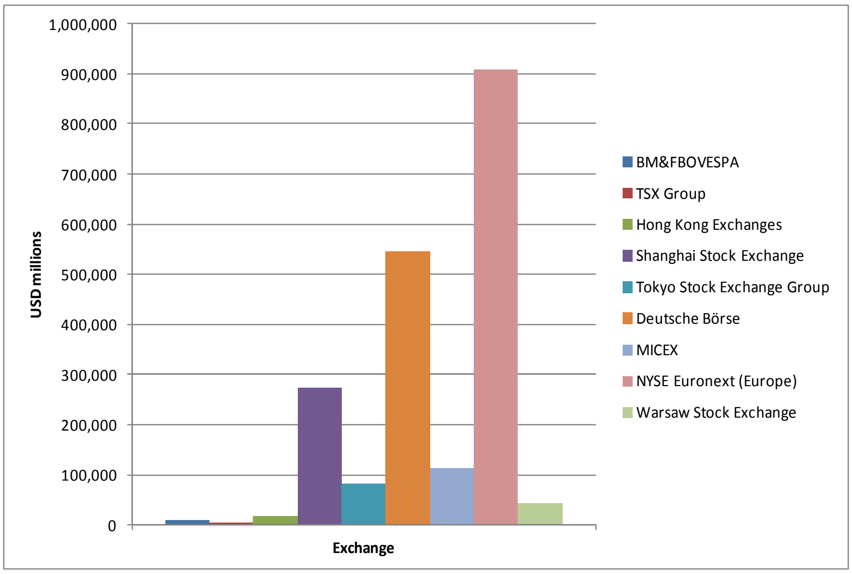


Figure 16. Outstanding international private securities as a % of GDP Russia versus selected groups[146]



144 World Bank, "FinStats", World Bank, 2011.
145 World Bank, "FinStats", World Bank, 2011.
146 World Bank, "FinStats", World Bank, 2011.

Figure 17. Amount of new capital raised by bonds (US$ millions) MICEX compared to leading exchanges, 2010[147]



Note: Bars from left to right correspond to legend names from top to bottom.

128. **Across other data on how MICEX compares to leading exchanges, it shows it is consistently not the thinnest nor the shallowest market.** For example, Table 9 and Figure 18 show that on the number of bonds listed MICEX is a larger market than several regional exchanges. This is supported by the data on the total value of bond transactions (Tables 10 and 11, and Figure 17 on bonds traded, listed and issued).

Table 9. Number of bonds listed, MICEX compared to Leading regional and global exchanges, 2010[148]

Exchange	Number of bonds listed
BM&FBOVESPA	287
TSX Group	196
Hong Kong Exchanges	169
Shanghai Stock Exchange	472
Tokyo Stock Exchange Group	335
Deutsche Börse	24,839
MICEX	*788*
NASDAQ OMX Nordic Exchange	5,062
NYSE Euronext (Europe)	3,978
Warsaw Stock Exchange	137

147 World Federation of Exchanges, 2011.

148 World Federation of Exchanges, 2011.

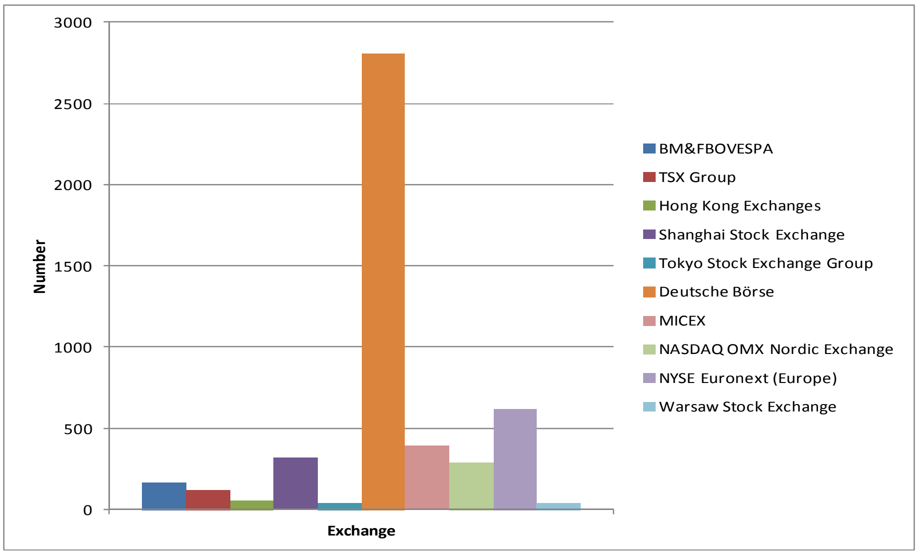
Table 10. Total value of bond trading (US$ millions), 2010
MICEX Compared to exchanges in leading financial centers[149]

Exchange	Total value of bond trading, USD millions
BM&FBOVESPA	249
TSX Group	5,665
Australian Securities Exchange	602
Hong Kong Exchanges	1
Shanghai Stock Exchange	76,020
Tokyo Stock Exchange Group	4,205
Deutsche Börse	109,999
MICEX	*231,420*
NASDAQ OMX Nordic Exchange	2,619,509
NYSE Euronext (Europe)	27,172
Warsaw Stock Exchange	520

Table 11. Total value of bonds listed (US$ millions), 2008-2009
MICEX Compared to leading regional and global exchanges[150]

Exchange	Total value of bonds listed (USD millions)
BM&FBOVESPA	81,426
TSX Group	17,601
Hong Kong Exchanges	62,829
Shanghai Stock Exchange	720,778
Tokyo Stock Exchange Group	7,881,629
Deutsche Börse	12,874,673
MICEX	222,285
NASDAQ OMX Nordic Exchange	2,669,573
Warsaw Stock Exchange	165,241

Figure 18. Number of bond issuers, MICEX versus leading exchanges, 2010[151]



Note: Bars from left to right correspond to legend names from top to bottom.

149 World Federation of Exchanges, 2011.
150 World Federation of Exchanges, 2011.
151 World Federation of Exchanges, 2011.

c. Asset-Backed Securities, Money Markets, Foreign Exchange, and Derivatives

Asset-backed Securities

129. **The market for asset-backed securities is almost non-existent though VTB has done a few securitizations of mortgages and automobile loans.**[152] As was suggested earlier, the issuing of secured bonds by banks could be used to fund ruble-denominated mortgages and to finance an expansion of leasing to SMEs. In particular, the market for mortgage securities is largely inactive because of inflation, possible distortions in the pricing of interest rates, the narrow base of institutional investors as well as some legal constraints concerning the length of mortgage registration, foreclosure duration, difficulties with transfers to a servicing agent, and the lack of standardized disclosures by borrowers. For other asset classes many of the transactions are "cross-border" due to insolvency risks, complicated access to collateral, insufficient rules for the assignment of future receivables, the lack of back-up service regulation, and fears over the potential tax consequences of securitization deals.

130. **To begin solving some of these problems the legislation for mortgage securitization requires wider access by institutional investors to such securities; as well as making securities eligible for domestic repo transactions.** As well simplification of the issuance of securities should be done; allowing for more flexibility in choosing the tranching schemes; the introduction of escrow accounts; and the development of collateral rules. On a practical level the government needs to identify and eliminate the pricing distortions on the market which prevent commercial banks from becoming active borrowers, in order to help domestic institutional investors implement internal methods of pricing and risk-based capital allocation for such instruments. Furthermore, SPVs should enjoy minimum taxation and the process of obtaining tax determination should be transparent. The new rules for securitization of other types of (non-mortgage) assets should allow for a variety of deals and conditions for applying international standards (such as ISDA and the UN Convention on Assignment of Receivables).[153]

The Money Market

131. **There are three parts to the money market: (i) an interbank market in unsecured deposits among the fifteen largest banks; (ii) a market for repos; and a (iii) market for bills of exchange (veksels).** The repo market is the major source of liquidity for the many small and medium-sized banks. These lack a base of retail deposits, since retail banking is largely monopolized by the large state banks – particularly by Sberbank. They also lack the credit to participate in the interbank market in unsecured deposits. The principal suppliers of liquidity in the repo market are the large banks. In recent years, the repo market, in addition to its role in

152 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

153 See annex 2 for a further discussion of these solutions.

redistributing liquidity between large and small banks, has been exploited by participants to establish highly-leveraged carry positions in bonds.[154]

132. **The principal venue for repo transactions is MICEX.** With the shortage of government securities, the range of collateral has expanded to include corporate debt and equities. Daily volume on a typical day (Oct 28, 2011) was over RUB 80 billion of equity repos, and RUB100 billion of bond repos.[155] The term of the great majority in both cases was overnight.

133. **Bills of exchange, known as veksels, are a medium of payment between firms.** The recipient generally discounts the bill with a bank. The market is brokered by a number of small specialized brokers, and there is a rating agency "Cbonds" that rates the paper. The market is governed by an association (AUVER) with some 110 members. In early 2010, the size of the market was about RUB 600 billion (approximately US$ 20 billion).[156] The market is unregulated, and concerns have been expressed about possible risks to the banks involved.[157] Those concerns seem overblown, since bills of exchange, as "two-name" liabilities, are if anything safer than a regular bank loan on a single name (and veksels are also more liquid). The registration fee for bonds had the effect of diverting business to the veksel market, as veksels are not subject to the fee. Since the registration fee was reduced, the veksel market has shrunk as the bond market expanded.

Forex and Derivatives[158]

134. **There is a well-developed foreign exchange market – some exchanges, mainly the MICEX, account for about 30 percent of total trading.** The remainder takes place on an interbank OTC market. There are three major brokers. The market is unregulated, but it is stabilized by intervention of the CBR.

135. **There are a number of derivatives markets in addition to the derivatives on equities already mentioned.** Currency derivatives trade mostly on MICEX, but also on the St. Petersburg Currency Exchange (SPCEX). MICEX also trades futures on the overnight interest rate (MosIBOR) and on the three-month rate (MosPrime). All trade in options takes place on RTS (FORTS): options traded include those on currencies and commodities. There are markets in currency swaps on MICEX and OTC from banks. There are no interest-rate swaps, because the legal basis has not been established. (See the Annex for data on derivatives trading on MICEX and RTS compared to some of the leading exchanges).

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154 IMF and World Bank, "Financial Sector Assessment Program: Russian Federation, Technical Note: Liquidity Management Issues", IMF and World Bank, 2008; Economist Intelligence Unit Country Finance Russia May 1, 2011.

155 See http://www.micex.com/marketdata/indices/today (data accessed on October 29, 2011).

156 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

157 For example, Noel, Kantur, Op cit.

158 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

d. Regulation of Financial Markets

136. **In regulating capital markets, it is important to keep the goal in mind – the goal is to make Moscow more competitive with the global financial centers as a venue for financial transactions – first of all for Russian traders, and Russian securities.** One crucial factor in this competition is transaction costs. The way to lower transaction costs is to reduce red tape and to simplify regulations and procedures. In general, that means consultation with market participants to identify where changes are necessary. And it means relying as much as possible on self-regulation of market firms and professionals through SROs.[159] FFMS is already doing this to some extent—relying on NAUFOR to enforce compliance by brokers, and on PARTAD to supervise registrars, depositories, and clearinghouses.[160]

137. **Of course, the problems of the general business environment – absence of rule of law, corrupt and inefficient administration, and an inefficient and unpredictable legal system – are of particular importance here, since they all raise transaction costs significantly.** As was suggested in the introduction to this report, a fruitful approach might be to isolate financial markets from the general environment by providing them a separate legal and administrative framework of their own.

The Markets[161]

138. **Regulation of financial markets may be divided into three categories – regulation of the markets themselves (exchanges and broker-dealers), regulation of the securities traded (the process of issuing, what kind of securities may be issued, etc.), and regulation of the issuers (corporate governance, insider trading, takeovers, etc.).** The back-office functions of the securities markets are made cumbersome – and consequently more costly – by deficiencies in the legal framework for depositories, custodians, and registrars (Box 8).

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159 However, the arbitrage courts of the SROs are relatively unpopular, and public arbitration (regular courts) may be cumbersome for claims of large classes of investors.

160 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011. NAUFOR is the National Association of Securities Market Participants; PARTAD is the Professional Association of Registrars, Transfer Agents and Depositories.

161 See Annex 2 for more information on the recommendations in this section.

Box 8. Constraints in the Financial Infrastructure of the Securities Market

Issue	Measures Recommended
Insufficient legal protection of ownership transfer and settlement. In some cases it is difficult to restore property rights for non-documentary securities buyers. The registration acts of registrars and depositories are slow and not synchronized, the uniform registration practices and accepted guarantee forms across the system are lacking (often all underlying documentation is required to finalize the ownership transfer) and electronic signatures are not widely used. Due to the above legal infrastructure risks, settlement is performed in most cases on pre-payment and pre-delivery terms, and CCP-like settlement until now has been custom-tailored and lacks legislative support, which is expected to improve with the introduction of the new Clearing Law and multi-party netting.	Legal rules protecting buyers of non-documentary securities should be harmonized; and registrars and depositories connected within a system. Using a uniform electronic signature and security number for easy verification of securities balances at a given time is crucial for synchronized trading and registration of large volumes of dematerialized securities as in other financial centers. The development of insurance standards and guarantee mechanisms (fund or insurance-type schemes) for registration of system participants should proceed (such mechanisms should be imbedded in the overall system of Central Clearing and tailored according to the risk-taking of market participants and their prudential requirements). Immobilization or dematerialization of securities in the central depository whose records have prevailing legal standing would reinforce settlement finality by affirming that what constitutes property cannot be altered by other legal events or agreements.
Operational infrastructure inefficiency. Fragmented infrastructure, where participants use systems that are not compatible, do not have corresponding accounts with each other, and have a high share of paper-based document turn-over, combined with legal issue of registration entry priority (depositories vs. registrars) result in difficulties achieving settlement finality and may result in very high load on the system with regard to corporate actions, safekeeping etc., as the market turnover grows. With regard to cross-border transactions, restrictions on nominal accounts for foreign custodians complicate creating the inter-depository relations with Russian depositories, combined with the 25 percent limit on ownership of shares of state monopolies and some financial companies, and rules disallowing direct trading (through nominal accounts) in domestic securities for foreign investors, which limits access of foreign institutional investors to the Russian market and increases clearing duration.	As referenced above, the settlement system should comprise registrars and depositories through a network of correspondent accounts, and use standardized electronic forms/programs/codes. To achieve this, the law should allow wide usage of electronic messages based on SWIFT and ISO standards, which, combined with lifting limitations on nominal accounts for foreign custodians, will ease access for foreign investors and make the system compatible with financial centers. The obligatory paper requirement for transaction documentation should be waived in favor of approved electronic messages. Similar uniform standards should be used by OTC platforms. The government, with support of SROs should develop a single official source of information on corporate actions to reduce system load related to various actions. An integrated securities registration and transfer system linked to foreign settlement systems through correspondent accounts with foreign custodians, would bring the Russian market in line with practices used in other financial centers. Market regulators can consider simplifying access by foreign investors, by allowing direct trading subject to a condition that a nominal account with a Russian custodian is used, or clearing through a licensed Russian clearing agent.
Low market liquidity, an insufficient number of securities offered for trading domestically, and a need to develop a small and medium investors class. Smaller issuers are constrained by a complex securities issuance and registration system (exclusions from prospectus registration for private placements and small offerings are not fully available, as in other markets), while large issuers limit their stock offerings on domestic markets due to their aim to maintain concentrated stock ownership. To address the market liquidity issue, the law limits the issuance of ADRs which, in turn, create obstacles for large issuers to raise capital abroad, and prevent the formation of a securities fair-market value on the internal Russian market.	A more efficient way to boost the internal market efficiency would be by creating a favorable climate for smaller issuers on the domestic market, increasing the instrument base, and market liquidity by simplifying share issuances for smaller companies/issues, and the trading rules for smaller companies. More detailed rules are needed as to when the issues are not subject to prospectus registration, and elimination of the report on results of the offering, for medium size and small issuers. or When a professional intermediary is involved, the concept of restricted securities needs further definition.
A need for better investor protection. As the market and number of small investors grow, it calls for more efficient public arbitration and private arbitration (SROs arbitration); current practices are detrimental for formation of trust in SROs as the implementers of the regulator's policies. The arbitrage courts of SROs are relatively unpopular, and public arbitration (regular courts) may be cumbersome for claims of large classes of investors that are specific to securities-related disputes. The	For public arbitration, in addition to recently introduced ground rules for class action suits, additional rules are needed for better protection of group members' rights, such as publication of pending actions, detailed settlement rules, publication of the actions filed, etc. For private arbitration, the courts' independence should be ensured by requiring a majority of non-affiliated members on the courts, setting the standards for arbitration and rules of conduct, excluding concerns over validity of private

retail investors will also need better protection from illegal insider dealing, where there are still some open issues at the legislative level (status of persons holding securities indirectly, beneficial ownership disclosure, acquiring insider info without having an employment relationship with issuer, rules for specific trades such as those based on knowledge about upcoming research, etc.) and at a practical level (possibility of dispersion of control and monitoring functions between the regulator and SROs, compatibility of their monitoring systems). There is a concern that insider dealing monitoring, instead of assisting investors in obtaining the fair market price, can be used as an instrument for spreading the regulator's control over the market or supporting certain players.	arbitration clauses in stock exchange rules for central counter-party transactions, and overcoming existing fragmentation of the private arbitration system. To achieve maximum transparency of a system of insider dealing monitoring, it should avoid dispersion of control and conflict of interests. Monitoring by SROs should minimize the conflict of interest and exercising market monitoring; tracking of insider dealing by market participants should be based on the fiduciary duties to their clients. SROs' and regulators' monitoring systems should be compatible and use standardized forms/messages for information exchange; and an adequate case management system is needed to assist the monitoring and inspections by regulator and SROs. Better rules on disclosure of beneficial ownership, persons holding interest indirectly, trading rules for professional market participants prohibiting trading based on research information, or future block trades for futures, are necessary for effective monitoring and law enforcement. These measures should be aimed at creating the real time filing of insider alerts, to help avoiding duplication of monitoring functions between the regulator and SROs, and to ensure that all investors obtain benefits of trading securities at their fair market value.
Securitization does not serve as a bank refinancing tool. The market for mortgage securities is not active preventing efficient refinancing of financial institutions due to low demand for long term instruments because of inflation, as well as possible securities pricing and interest rate distortions in the economy, a low institutional investor base, as well as some legal constraints (length of mortgage registration, foreclosure duration, difficulties with transfer to a servicing agent, no standardized borrower disclosure, etc.). For other classes of assets, most transactions are "cross-border", due to the risks during insolvency, complicated access to collateral, risks of voiding transactions by a crisis manager, insufficient rules of assignment of future receivables, a lack of a back-up servicer regulation, and potential tax consequences of securitization deal.	The legislative basis for mortgage securitization requires wider access of institutional investors for investing in such securities, making securities eligible for domestic repo transactions,, simplifying the issuance of securities, allowing for more flexibility in choosing tranching schemes, introducing escrow accounts, and, developing collateral rules. On a practical level, the government needs to identify and eliminate the pricing distortions on the market which don't allow commercial banks to become active borrowers, in order to help domestic institutional investors to implement internal methods of pricing and risk-based capital allocations for such instruments. The SPVs should enjoy minimum taxation (VAT on asset transfer, servicing fees, income tax) and the process of obtaining the tax determination should be transparent. The new rules for securitization of other types of assets (non-mortgage) should allow for variety of deals and conditions for applying international standards (ISDA, the UN Convention on Assignment of Receivables, etc.)
Collateral Rules are significantly lagging behind foreign practices due to a requirement for individualization of rights/assets, a limited range of assets as collateral, unfavorable taxation (VAT applied when collateral is claimed), as well as cumbersome collateral registration, no pledge of rights, difficulties with out-of-court enforcement, restrictions on depositories to engage in securities transactions without orders of the depo account holders thus preventing meeting obligations in timely manner, and difficulties with repossession of collateral for some types of assets.	The magnitude of legislative gaps calls for a significant collateral rules reform, to allow contractual freedom to determine the terms of collateral and the events of default, to establish the uniform collateral registry, allow automatic extension of a security to future of after-acquired assets (continuous protection regardless of the method it was acquired), giving secured creditors absolute rights to their collateral outside bankruptcy procedures, ease repossession of collateral, and extend the range of assets/rights where security can be obtained
Foreign Currency. The new currency law lifted many restrictions. Regulation is adequate but some issues remain. Settlement in forex is not available to residents, the list of allowed transactions is exhaustive (not open, which would give more flexibility), and overdrafts and cash balances are not often used due to depositories' settlement rules (pre-payment, pre-delivery).	Settlement in foreign currency needs to be made available to domestic investors, and some efforts need to be made by the regulator to promote efficient implementation of the new currency rules by authorized banks. If the task is to create a financial center, the entry barrier for investors should be low and the exit cost minimal.

139. **For example, it is difficult to restore property rights for non-document based securities buyers; the registration practices of registrars and depositories are slow and not synchronized; and there is a lack of uniform registration practices and accepted guarantee forms.** This is on top of the fact that all underlying documentation is often required to finalize

the transfer of ownership and the use of electronic signatures is not widely practiced. Furthermore, settlement is performed in most cases on pre-payment and pre-delivery terms, but until recently Central Counter-Party-like settlement (CCP) was custom-tailored and lacked legislative support. Recommendations for improvement in this area are the harmonization of legal rules protecting buyers of non-documentary securities, the connection of registrars and depositories, and the development of insurance standards and guarantee mechanisms.

140. **Market participants also use infrastructure with incompatible systems.** This means that they might not have corresponding accounts with each other and have a high turnover of paper-based transactions. These issues, combined with problems over registration, mean it can be difficult to achieve settlement and may result in the system being overloaded with transactions as the market grows. Furthermore, the access of foreign institutional investors is limited by (i) restrictions on nominal accounts for foreign custodians (which hampers the creation of inter-depository relations); (ii) the ceiling of 25 percent that is applied to any foreign ownership of state firms and some financial companies; and (iii) rules that disallow direct trading (through nominal accounts) in domestic securities.

141. **Solutions to these problems include development of the settlement system so that registrars and depositories are linked through a network of corresponding accounts, and the use of standardized electronic forms and codes such as SWIFT and ISO.** Overall, an integrated securities registration and transfer system that is linked to foreign custodial and settlement systems through the system of corresponding accounts in foreign custodians, would bring the Russian market into line with practices used in other financial centers. The market regulators could also consider simplifying access of foreign investors by, for example, allowing direct trading subject to the condition that a nominal account with Russian a custodian is used, or clearing through a licensed Russian clearing agent.

The Securities

142. **As already noted, in the context of the bond market, the complex and burdensome nature of the process of registering a new issue, the stamp tax on registration, and the restriction in the Civil Code on the amount of issue permitted are obstacles.** These obstacles to the expansion of financial markets should be removed. Simplification and clarification of the laws relating to securitization and collateral would facilitate the development of the market for asset-backed securities. It would also be helpful to create a centralized register of collateral that would ensure that the same assets are not pledged more than once simultaneously. At the moment problems include the requirement for the over-individualization of rights and assets; the limited range of assets that is available for collateral; unfavorable taxation (not least the application of VAT when collateral is claimed); cumbersome collateral registration; difficulties with out-of-court enforcement; restrictions on depositories engaging in securities transactions; and difficulties with repossession of collateral for some types of assets.

143. **More could be done to facilitate integration of the Russian and global securities markets – as already noted, in the context of the equities market, there is a need to remove obstacles to the offering of Russian securities on global markets and to the participation of foreign investors in the Russian market.** This report noted the 2009 law that established the basis for RDRs, making access easier for foreign issuers. Further effort could be made through allowing certain contractual freedom to determine the terms of collateral and the events of default; the establishment of a uniform collateral registry; the allowing of automatic extension of securities (with continuous protection regardless of the method of acquisition); the granting to secured creditors the absolute right to their collateral outside of a bankruptcy procedure; the easing of the repossession of collateral; and an extension in the range of assets and rights for which security can be obtained.[162]

144. **The current legal environment makes it difficult to create new types of securities, because only those types specifically enumerated are permitted.** Every innovation, therefore, requires enabling legislation. Nor is a single enabling law sufficient: in each case, amendments must be made to the Civil Code, the Tax Code, the Law on Joint Stock Companies, the Law on Securities Markets, the Law on Insolvency (Bankruptcy), the Law on Foreign Currency Regulation, and the Law on Banks and Banking Activity.[163] The creation of a separate legal environment for the financial markets would make innovation much easier.[164]

145. **Important steps have been taken recently to create a legal framework for derivatives and derivatives trading.**[165] However, obstacles remain – for example, a law that prohibits banks and corporations from entering into financial contracts governed by the law of other jurisdictions.[166]

The Issuers

146. **The corporate governance problem in Russia is different from that in the English-speaking common law countries.** In the latter, the principal concern is of managers furthering their own interests at the expense of those of the dispersed owners. In Russia, as in continental Europe generally, because ownership is concentrated rather than dispersed, owners can control managers quite effectively. This, however, creates a different problem – that of the concentrated, insider owners furthering their own interests at the expense of the minority, outsider owners. Observers generally consider this problem to be a serious one in Russia.[167]

162 See Annex 2 for a broader discussion of the changes that could be made in this area.

163 See {Noel, Kantur, Krasnov and Rutledge on the legal steps necessary to allow the creation of asset-backed securities, Op. cit.

164 Settlement in foreign currency also needs to be made available to domestic investors, while the regulator needs to make effort to promote efficient implementation of the new currency rules by authorized banks. See annex 2 for more details.

165 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

166 IMF and World Bank, "Financial Sector Assessment Program: Russian Federation, Technical Note: Liquidity Management Issues", IMF and World Bank, 2008; Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

167 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

147. **One expression of the corporate governance problem is insider trading.** Past studies have called for legislation prohibiting insider trading and imposing strong penalties for those convicted of it.[168] A law prohibiting insider trading was passed in January, 2011; and it included a provision making insider trading a criminal offense beginning in 2015.[169] Specific problems include questions over the status of persons holding securities indirectly; beneficial ownership disclosure; the acquisition of insider information when there is no employment relationship with the issuer; the rules for trades based on knowledge about forthcoming research reports and suchlike; and the dispersion of control over monitoring functions between the regulator and SROs and the compatibility of their monitoring systems. There is also a concern that monitoring of insider dealing can, instead of assisting investors in getting a fair market price, be used as an instrument for the spread of regulatory control over the market or support for certain players.

148. **To maximize the transparency of the insider dealing monitoring system, dispersion of control and conflict of interest during monitoring must be avoided.** Monitoring by SROs should be done so as to minimize conflicts of interest during the exercise of market monitoring, while the tracking of insider dealing by market participants should be based on fiduciary duties to clients. Furthermore, the monitoring systems of SROs and regulators should be compatible and use standardized forms for information exchange, and an adequate case management system is needed to assist monitoring and inspections. However, it should be noted that given the particular circumstances of the Russian equities market, it seems unlikely that the new law on insider trading will prove helpful. Insider trading laws are not particularly effective anywhere: convictions are rare, and there is considerable evidence from the behavior of stock prices that insider trading continues nonetheless to be widespread.[170]

149. **There is also evidence that insider trading prohibitions are especially ineffective in countries, like Russia, characterized by concentrated ownership; indeed, in such markets, insider trading prohibitions may even worsen the problems of corporate governance.**[171] Furthermore, in Russia the insiders are mostly state officials and those connected to the state. Enforcement of the law against such individuals seems unlikely. Even in the United States, insider trading by officials is extensive.[172]

150. **Similarly, suggestions of new laws to ensure that minority shareholders receive a "fair" price in the event of a takeover are misplaced.**[173] Such suggestions make sense for the

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168 IMF and World Bank, "Financial Sector Assessment Program: Russian Federation, Technical Note: Liquidity Management Issues", IMF and World Bank, 2008; Noel, Kantur, Op. cit.

169 Fitzgeorge-Parker L, "Russian Capital Markets: Climate Change", *Euromoney*, May 2011.

170 See annex 2 for a more detailed discussion of the policy changes that might be employed in this area.

171 Durnev, A. A. and A. S. Nain (2005). The effectiveness of insider trading regulation around the globe, University of Miami/University of Michigan.

172 Smith K, "Insider Trading Rules That Don't Apply To Congress", *Forbes*, 1st June 2011; Brody Mullins, Tom McGinty and Jason Zweig, "Congressional Staffers Gain From Trading in Stocks", *The Wall Street Journal*, October 11, 2010.

173 Noel, Kantur, Op cit.

equities markets of the English-speaking common law world where takeovers involve the purchase of shares from the public in the open market (on the exchanges). In Russia, as seen, public trading on the exchanges involves only "non-control" shares; the trading of control interests presumably takes place in the OTC market, probably at significantly higher prices.

151. **Financial reporting and disclosure is yet another aspect of corporate governance.** In this area, there has been, in fact, some improvement in recent years, at least for the larger companies that wish to raise funds in the global financial markets.[174] In the global equities market, a lack of transparency—and other deficiencies of corporate governance—are penalized through lower prices for the stock of the companies in question. It has been estimated that the stock of Russian companies sell at a discount of something like 30 percent relative to the price they would fetch with corporate governance at the level common in more developed countries.[175] In debt markets, a lack of transparency raises interest rates and reduces the willingness to lend – in extreme cases, precluding lending altogether.

152. **The behavior of individual issuers affects the value of the securities they issue.** But it also affects the reputation of the market as a whole and so the willingness of investors to participate in it. That is the reason why, historically, exchanges have imposed listing requirements on the companies whose securities they trade – requirements that include standards of corporate governance. Publicly traded companies in Russia must satisfy both federal law and the relevant listing requirements. The two major exchanges have multiple classes of listing, with requirements of graduated severity. Listing is voluntary, and companies can decide whether or not to be listed and in which class.[176] Most decide not to be listed – 135 of the 192 traded on MICEX and 217 of the 290 traded on RTS.[177] Presumably companies choose not to list when the cost of compliance is greater than the benefit, in terms of a higher price for their stocks.[178]

153. **It has been suggested that listing should be required for companies beyond a certain size.** This does not seem justified. So long as investors understand what they are purchasing – including the information available to them – companies should be free to decide for themselves according to the costs and benefits. In the United States, for example, there is a large market for private placements, in which companies are not required to meet SEC standards for financial disclosure. In the long term, if the domestic demand for securities expands – in particular, as a result of the development of non-bank financial intermediaries – the rewards for higher standards of corporate governance will increase. More companies will then find it worthwhile to meet those higher standards.

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174 {Berglof and Lehmann, Op cit.

175 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, 2011.

176 There are also requirements as to market capitalization, size of float, etc, so not all companies are eligible to be listed in all categories, even if they wish to.

177 IMF and World Bank, "Financial Sector Assessment Program: Russian Federation, Technical Note: Liquidity Management Issues", IMF and World Bank, 2008

178 Smaller companies may not have the option to list if they fail to meet the lowest requirements for market capitalization, etc.

VI. Conclusions

154. **The development of Moscow as an international financial center requires a two-track effort focusing on expanding the domestic basis of the capital market while providing the regulatory environment and instruments for attracting foreign investors.** In the domestic market, an overlooked factor has been the need to expand the reach of financial services to individual investors and medium to small enterprises to provide a bedrock for the market. Incentives to attract Russian wealth deposited and invested abroad will also greatly contribute to the demand for new securities and suppliers of new investment opportunities and instruments.

155. **The dominance of state-owned financial intermediaries can put a damper on the development of a competitive market of institutional investors (investment funds, pension funds, insurance companies, brokerages).** Institutional investors should diversity the market via competition including increased entry of private sector players and foreign institutions. Besides market regulation (which can count on "imported" frameworks, self regulatory bodies, and other regulatory improvement measures), the corporate governance framework and transparent reporting standards need upgrading, and the legal process to register and verify ownership of tradable assets needs streamlining.

156. ***Synergies with banking services.*** The development and penetration of banking services across the country constitute a key element in expanding the reach of the financial markets into a broader retail investor base. This can help the non-banks (pensions, insurance, funds) markets to develop by counting on synergies in distribution and infrastructure.

157. ***Mechanisms to augment SME equity growth.*** Further access by medium and small enterprises to financial institutions will also generate potential candidates for eventual stock market listings and greatly increasing the free float of shares. A private equity industry can also help promote the development of start-up companies, potentially eventually supporting entrepreneurial initiatives emanating from the Skolkovo complex.

158. ***Setting the basis for the bond markets.*** In the bond market, pension and insurance companies demand long term securities but the market is currently shallow. Government proactivity in developing a deeper more liquid public debt market to establish a risk-free rate yield curve should be considered as it can form the basis of a latent private bond market that can attract both foreign as well as institutional investors into Russia, and increase circulation of Ruble instruments.

159. ***Benefits and obstacles in structured finance and derivatives markets.*** The derivatives sector, asset-backed securities, securitization and other structured finance markets need a close review to remove obstacles in the development of new and useful instruments while ensuring sound risk management features. Tax considerations and treatment of collateral should be

further examined in the context of these instruments as they present obstacles to the further development and liquidity of such markets.

160. ***Market Infrastructure Issues.*** The capital market infrastructure (registration, ownership transfer, settlement, collateral, and investor protection rules) needs to be upgraded in line with other global center standards to allow more automated and legally streamlined security sales and settlement safeguards.

161. ***A multi-pronged approach.*** The above implies that several market structure, regulatory and financial policy changes are needed to carve out an enabling capital market environment with the requisite institutions and financial instruments, to attract funding from overseas investors, domestic retail investors (individuals and SMEs), wealthy offshore Russian investors, and domestic institutional investors.

162. **Several of the above measures are absolutely necessary to move in the direction of transforming Russia into an international financial center – but they may not be altogether sufficient.** Additional general factors for achieving this goal include confidence in a suitable macroeconomic policy framework, user-friendly city transport, housing and education facilities (for foreigners residing or moving to Russia), and a reduction in regulatory barriers applicable to general business transactions including business registration, licensing, permits, trade transactions, paying taxes, and protecting investors.

Table 12. Derivatives trading, Russian exchanges compared to leading exchanges[179]

	Number of contracts traded		Notional value of contracts traded (USD millions)	
Exchange	**2010**	**2009**	**2010**	**2009**
Single stock options				
BM&FBOVESPA	802,229,293	546,547,550	1,730,007	931,053
Australian Securities Exchange	15,998,696	15,242,798	308,429	196,892
Hong Kong Exchanges	60,638,909	47,322,248	162,407	159,657
Tokyo Stock Exchange Group	833,995	660,875	1,555	772
NASDAQ OMX Nordic Exchanges	32,753,857	28,775,091	N/A	N/A
RTS	9,153,070	12,962,387	3,911	3,373
Single stock futures				
Australian Securities Exchange	152,724,068	141,662,095	2,036	1,617
Hong Kong Exchanges	239,259	271,766	907	900
MICEX	12,634,797	954,685	6,225	371
NASDAQ OMX Nordic Exchanges	2,468,839	6,718,987	N/A	N/A
RTS	226,505,131	248,669,083	84,511	66,841
Stock index options				
BM&FBOVESPA	640,278	818,521	121,405	68,889
Australian Securities Exchange	5,753,977	3,884,560	289,748	140,181
Hong Kong Exchanges	11,922,207	7,615,125	1,423,877	792,873
Tokyo Stock Exchange Group	120,040	52,523	12,926	5,118
NASDAQ OMX Nordic Exchanges	13,761,881	14,225,611	N/A	N/A
RTS	13,179,587	5,062,653	39,280	10,310
Stock index futures				
BM&FBOVESPA	38,683,263	31,588,752	898,224	631,397
Australian Securities Exchange	10,454,570	9,841,538	1,056,540	752,745
Hong Kong Exchanges	42,760,553	43,201,921	4,103,510	3,496,546
Tokyo Stock Exchange Group	15,834,007	16,234,911	1,482,984	1,409,703
MICEX	6,237,229	396,289	29,399	1,568
NASDAQ OMX Nordic Exchanges	32,427,695	33,700,054	N/A	N/A
RTS	227,162,075	150,057,414	678,910	303,224
Long-term interest rate futures				
BM&FBOVESPA	15,633	29,700	1,783	3,149
Australian Securities Exchange	47,124,262	33,874,590	4,322,490	2,661,632
Tokyo Stock Exchange Group	8,021,458	6,765,074	12,960,666	9,992,053
NASDAQ OMX Nordic Exchanges	7,401,693	5,715,755	N/A	N/A
RTS	133,048	27,745	364	295
Currency options				
BM&FBOVESPA	26,319,294	23,473,806	1,351,893	1,158,760
RTS	1,297,838	1,863,930	1,391	2,206
Currency futures				
BM&FBOVESPA	106,547,391	85,289,490	5,376,494	4,280,698
Australian Securities Exchange	-	1,003,633	-	673
MICEX	12,938,918	17,807,960	14,057	18,757
RTS	7,279,797	13,912,680	7,376	14,539
Commodity options				
BM&FBOVESPA	393,969	451,773	751	282
Australian Securities Exchange	16,169	10,303	5,026	3,288
RTS	145,457	85,500	201	84
Commodity futures				
BM&FBOVESPA	2,275,100	1,885,552	35,984	22,793
Australian Securities Exchange	230,293	194,669	11,747	8,709
Hong Kong Exchanges	5,462	6,773	102	96
RTS	17,784,436	11,164,828	18,296	8,192

179 World Federation of Exchanges, *IOMA/IOCA Derivatives Market Survey 2010*, World Federation of Exchanges

Annex 1 – Information and Features of Established Financial Centers versus Russia

Table 1: Hong Kong Financial Center: Banking Sector and Financial Sector Composition

Sector	Composition	Structure	Description	Regulator
Banking	- 142 Licensed Banks - 29 Restricted License Banks - 30 Deposit taking companies - 82 representatives offices of foreign banks	Three-Tier system of deposit taking institutions: i). Licensed Banks ii). Restricted License Banks iii). Deposit taking Companies Designated as Authorized Institutions (AIs) and subject to the 'Banking Ordinance' AIs may operate as either locally incorporated companies or branches of foreign banks	Only licensed banks able to operate current accounts and accept deposits of any size / maturity Restricted license banks principally engaged in merchant banking & capital market activities; may accept deposits of any maturity above HK$500,000 Deposit taking companies predominantly owned by licensed banks; restricted to taking deposits above HK$100,000 with minimum maturity of 3 months	Hong Kong Monetary Authority (HKMA) AI's subject to the provisions of the 'Banking Ordinance' requiring them to i). maintain adequate liquidity and capital adequacy ration's; ii). Submit periodic statistical returns to HKMA; iii). Adhere to limitations on loans determined by the 'Banking Ordinance'; iv).seek HKMA approval for appointment of directors, chief executives, changes in governance Overseas which operate as 'branches' are not required to hold capital in Hong Kong and are not subject to capital adequacy rations or capital based limits in large exposures Depositors protected via 'Deposit Protection Scheme'
Foreign Exchange Market	Open (various participants and mediators: wholesale and retail)	Absence of exchange controls (free market) Linked to leading international foreign exchange markets around the world	Hong Kong operates an open foreign exchange market marked by the absence of exchange controls	Hong Kong Monetary Authority (HKMA) Settlement systems stipulated via the 'Clearing and Settlement Systems Ordinance" with specified settlement systems for

		Linked Exchange rate system of Hong Kong Dollar to US Dollar		specific instruments under the 'Central Moneymarkets Unit' of the HKMA. These include: : i). Hong Kong Dollar Clearing House Automated Transfer System ii). Continuous Linked Settlement (CLS) System iii).Euro Clearing House Automated Transfer System iv).US Dollar Clearing House Automated Transfer System v). Renminbi Clearing House Automated Transfer System
Debt Market	Open pool market	Daily turnover averages HK$48.4 billion	One of the largest and most liquid debt markets in the region.	Central Money Market Unit Service (CMU) established in 1990 under the auspices of the HKMA provides clearing and custodian system for the exchange of bills and notes
Money Market	Inter-bank Market Utilized by institutions at the wholesale level	Hong Kong Interbank Offer rate determined by supply / demand for funds between market players. Lead indicator of the price of short term funds		Hong Kong Monetary Authority (HKMA)
Equities Market	Hong Kong Exchanges and Clearing Limited (HKEx) (private listed company but empowered with listing approvals and registration, audit and compliance of register companies) Non restricted and open trading	- Securities Market - Derivative and futures Market	Comprised of a securities and futures / derivative market Provides full Clearing and Settlement Services, Depository & Common Nominee Services Trading Mechanism	Securities and Futures Commission (SFC): Facilitates and encourages participation in the Hong Kong Markets; formulates regulatory policy and compliance requirements; regulates approved share registrars; oversees investor

	platform subject to compliance with the rules and requirements of the HKEx Interlinked with various global bources to enable trades on multiple exchanges			compensation funds; responsible for transparency and rectitude of markets and information symmetries; works with the HKEx and clearing houses to ensure transactional efficiency, systems innovation and product development
Precious Metals Market	The Chinese Gold and Silver Market (founded in 1918).	Open platform subject to participant registration for clearing and settlement purposes	Enjoys key position in the international gold market	The Chinese Gold and Silver Exchange provides a trading place, facilities and related services to its members for gold, silver and precious metals transactions; establishes and implements rules and regulations, and normalizes precious metal transactions; oversees the transaction process, settlements and delivery arrangement; designs trading contracts and regulations, and to monitor the fulfillment and completion of the contract.
Asset management	Assorted wealth and asset management companies	Institutional fund management Portfolio management Personal wealth management Unit trusts and mutual funds	One of the largest asset management centers in Asia ; regional centre for portfolio management activity	Subject to oversight by the HKMA and normal listing / registration requirements.
Derivatives Market (Futures)	Hong Kong Futures Exchange (HKFE)and Stock Exchange of Hong Kong (SEHK) Derivatives market composed of four types of futures: i). Index futures; ii). Stick futures; iii). Interest rate futures; iv).	Transactions on the two exchanges cleared / settled via the Hong Kong Securities Clearing Company (HKSCC) and the Stock Exchange of Hong Kong Options Clearing House Company (SEOCH) and the Hong Kong Futures		

		Exchange Clearing Corporation (HKCC)		
Insurance	Open non restricted participation subject to approval of the Insurance Authority.	181 authorized insurers (90 incorporated in Hong Kong). Sector mainly composed of large, international insurance companies (retail and re-insurance).	Marine, aviation, insurance on structured financial products, retail, life, health; reinsurance	Office of the Commissioner of Insurance (OCI) heads Insurance Authority (IA). Mandated by the Insurance Companies Ordinance which allows for the prudential supervision of all insurance business operating in Hong Kong regardless of the place of inc OCI responsible for development of policy and prudential regulatory measures

Table 2. Information on the Russian Market and Regulations as a Financial Center

Sector	Composition	Structure	Description	Regulator
Banking	21 state-owned banks 844 other local banks 90 majority foreign-owned banks.[180]	Structure as implied by composition.	State-owned banks enjoy implicit government support and the most competitive position in the market place. The largest state-owned bank, Sberbank, accounts for 48 percent of all retail deposits.[181] The privately-owned banks operate from a less competitive position.[182]	The Central Bank of Russia. Its core remit is to maintain ruble stability, "develop and strengthen" the banking system and ensure the operation of the payments system.[183]
Foreign exchange (FOREX) market	Open.	The ruble has been in a free-float regime since September 2nd 1998, but is subject to intervention from the Russian Central Bank.[184] Some restrictions on currency transactions and convertibility remain.[185]	Russia is the 14th largest regional market by share (0.8 percent) of the global foreign exchange market.[186]	The market is not regulated.[187]

180 International Monetary Fund, *Russian Federation: Financial System Stability Assessment*, International Monetary Fund, 2011, p 40

181 Sberbank, "Sberbank Today," http://www.sbrf.ru/en/about/bank_today/

182 International Monetary Fund, "Financial Sector Assessment Program Stability Module: Russian Federation: Aide-Memoire – Preliminary," International Monetary Fund, April 2011, p 16

183 See article three of the Federal Law on the Central Bank of the Russian Federation (http://www.cbr.ru/eng/today/status_functions/)

184 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 38 and See article three of the Federal Law on the Central Bank of the Russian Federation (http://www.cbr.ru/eng/today/status_functions/)

185 See Central Bank of Russia, "Banking Legislation," Central Bank of Russia (http://www.cbr.ru/eng/analytics/bank_system/print.asp?file=bank_laws_e.htm); and Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 38

186 Bank for International Settlements, *Triennial Central Bank Survey: Foreign Exchange and Derivatives Market Activity in April 2010*, Bank for International Settlements, 2010, p 11

187 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 49

Debt market	Bonds, Eurobonds, and IUFs are traded.[188]	Trading on two exchanges, MICEX and RTS.[189] There are two types of government bond, GKO (government short-term commitment) and OFZ (federal loan obligation). In addition to the federal government, regional and municipal governments issue bonds.[190] Only licensed participants may buy treasury bills in central bank auctions.[191]	The majority of trading takes place on MICEX. The debt market is small. In 2009 neither outstanding public debt securities, nor outstanding private debt securities, were equal to more than 5 percent of GDP.[192] The market lacks long-term securities.[193]	The Federal Financial Markets Service (FFMS) and, for bonds issued by banks, the Central bank of Russia.[194]
Money market	Interbank market. Commercial paper is traded. Three types of repo are traded: direct, reverse and interdealer.[195]	The commercial paper market is a market for unsecured corporate promissory notes, or "veksels."[196]		The commercial paper, or "veksel" market is unregulated.[197]
Equities market	Primary market (IPOs) and a secondary market.	There are two markets, MICEX and RTS.	MICEX accounts for around three-quarters of exchange-based equity trading. The two exchanges are	The Federal Financial Markets Service (FFMS).[199]

188 MICEX, "Listing Securities," http://www.micex.com/markets/stock/securities/listing

189 MICEX, "Listing Securities," http://www.micex.com/markets/stock/securities/listing; RTS, "About RTS", http://www.rts.ru/s602

190 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 55

191 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 55

192 World Bank, "FinStats"

193 International Monetary Fund, *Russian Federation: Financial System Stability Assessment*, International Monetary Fund, 2011, p 24

194 Federal Financial Markets Service (see http://www.fcsm.ru/); Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 73

195 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 56

196 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 57

197 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 57

			currently going through a government-initiated merger.[198]	
Precious metals and commodities market	Minerals, metals, power and soft commodities are traded.[200]	Three exchanges, MICEX, RTS and the Interregional Oil and Gas Exchange (MBNK).[201]		
Derivatives market	Single stock futures, equity index futures, interest rate futures, commodity futures and currency futures are traded.[202] Around 70 American-style options are traded.[203] Two types of one-day currency swaps are traded, "overnight" and "tomorrow/next."[204]	There are two main markets, Futures and Options on RTS (FORTS), and MICEX.	FORTS, launched in 2001, holds the majority of the market for all derivatives bar currency futures, which are mainly traded on MICEX.[205] All options trading takes place on FORTS.[206] Currency swaps are traded on MICEX, over the counter with Russian banks, and with the Central Bank of Russia.[207] FORTS is ranked the tenth largest derivatives exchange worldwide. MICEX is ranked 33rd.[208]	There is no legislation on derivatives.[209]
Insurance	There are 625 insurers.[210]		The top three insurers account for around 15 percent of all premiums. A	In 2011 the insurance regulator, the Federal Service of Insurance

199 Federal Financial Markets Service (see http://www.fcsm.ru/)

198 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 60

200 RTS Exchange, "RTS Stock Exchange and Commodities Market," RTS, 23rd February 2011

201 RTS Exchange, "RTS Stock Exchange and Commodities Market," RTS, 23rd February 2011

202 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 50

203 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 50

204 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 51

205 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 50

206 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 50

207 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 51

208 Acworth W, *Annual Volume Survey 2010*, Futures Industry Association, 2011, p 4

209 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 51

210 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 21

			majority of the biggest companies are domestically owned.[211]	Supervision which earlier was a Unit reporting to the Ministry of Finance, was transferred and merged with the FFMS. It still has its regulatory role but as a part of the super-regulator, the FFMS which now covers securities, insurance, asset management and pensions.[212]

211 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 21/22

212 Economist Intelligence Unit, *Country Finance: Russia*, Economist Intelligence Unit, May 2011, p 23

Table 4: Singapore Financial Center: Banking Sector and Financial Sector Composition				
Sector	**Composition**	**Structure**	**Description**	**Regulator**
Banking	- 114 Commercial Banks - 33 Full Banks - 41 Wholesale Banks - 40 Offshore Banks - 50 Merchant Banks - 36 Representative Offices of Banks	Three-tier system of commercial banks: full banks, wholesale banks, and offshore banks.	Full banks provide the whole range of banking business approved under the Banking Act. Wholesale banks do not carry out Singapore Dollar (SGD) retail banking activities. They operate within the Guidelines for Operations of Wholesale Banks issued by MAS. Offshore banks can engage in the same activities as full and wholesale banks for businesses transacted through their Asian Currency Units (ACUs).	Monetary Authority of Singapore (MAS) The MAS is responsible for the regulation/ supervision of the banking sector: i). implementing monetary policy; ii). supervisor of the banking systems; iii). banker to the government; iv). banker to the banks; ⅴ).controller of international reserves; ⅵ).issuer of currency; ⅶ).issuer of banking licenses; ⅷ).lender of last resort Merchant banks are approved under the MAS Act and their operations are governed by the Merchant Bank Directives.
Foreign Exchange Market	Open (after SGD was floated in 1973, banks were free to quote exchange rates)	Absence of exchange controls (free market) It follows a floating foreign exchange system and links Exchange rate system of SGD to US Dollar.	SGD is one of the 11 currencies in the Continuous Linked Settlement (CLS). This eliminates foreign exchange (Fx) settlement risk. The average Fx daily trading volumes reached to US$229 billion in October 2007 average daily Fx turnover reached US$231 billion .	Singapore Foreign Exchange Market Committee (SFEMC), sponsored by MAS. By 1 June 1978, Singapore has completely removed its exchange control regulations. SFEMC published *Singapore Guide to Conduct and Market Practices for Treasury Activities* as the standard and code of Fx market activities.
Debt Market	Debt securities include bonds, debenture, loan stock, NCDs and others.	It is comprised of corporate debt market and Singapore	770 companies with a combined market capitalization of S$671 billion.	Incentives have been given to financial institutions with approved Bond

		Government Securities (SGS, inc. treasury bills, SGS bonds).	SGS market counties to grow.	Intermediary (ABI) status. The *Qualifying Debt Securities* (QDS) scheme was granted to investors.
Money Market	- Inter-bank Market - Discount Market The major participants in the market are commercial banks, merchant banks, money brokers and MAS.	All four discount houses are joint ventures by major local banks and foreign finance groups.	The interbank market refers to transactions among the banks. The basic function of Discount Houses is to accept short-term funds from commercial banks, and to a lesser extent from other financial institutions.	Monetary Authority of Singapore (MAS) Under the Banking Act, commercial banks are required to maintain accounts with MAS. The major instruments are: ⅰ). Treasury bills; ⅱ).government stocks and bonds; ⅲ). bills of exchange; ⅵ). negotiable certificates of deposit.
Equities Market	- Primary market - Secondary market	Several methods to raise capital in the equity market: public issue, offer for sale, private placement, bonus issue and rights issue.	A primary market for issuing new equities, including shares. The secondary market, the stock exchange, is where these equities traded after flotation.	Companies that have raised equity capital through public subscription have to seek a listing on the Singapore Exchange (SGX).
Gold and Commodities Markets	Gold market is comprised of 2 major segments: - Spot market (including Loco London market and Singapore kilobar market) - Futures market Singapore Commodity Exchange (SICOM): trading of commodity futures (e.g. Rubber)	Companies, individuals, residents as well as non-residents are allowed to participate freely in. Gold bars of the light-weight class are also traded in the physical gold market.	SICOM maintains a computerized network that links the market makers and the brokers. All contracts are cleared through the Clearing House.	Committee on Rubber Trading (CRT) oversee the privatization of Rubber Association Singapore.(RAS)
Asset Management	The collective investment schemes (CIS) include the unit trust, money market fund, property fund.	Other financial institutions, such as banks and insurance companies, are involved in the	Recognized as one of the premier asset management centers in the Asia Pacific	MAS support for the asset mgt industry by introducing incentives: ⅰ).enhancement to

	Alternative investment: Real Estate Investment Trusts (REITs), private equity, venture capital and hedge funds.	asset management.		the tax exemption scheme for foreign investors; ii). Enhancement to the tax exemption of income of foreign trusts scheme; iii). Enhancement to the Designated Unit Trust (DUT) scheme. The listing of investment funds on the SGX-ST are required to follow the listing criteria.
Asian Dollar Market	Sources from central banks, government agencies, commercial banks and other financial institutions. Non-bank sources include MNCs, affluent individuals, and business firms involved in international trade.	In relation to the wider concept of international capital market. It is comprised of financial institutions borrowing and lending dollars and other currencies outside the countries of origin.	The market is an international financial market where institutions accept the deposit of hard currencies outside their countries of issues.	Financial Sector Incentive (FSI). ACUs are automatically granted the Standard Tier award for five years.
Derivatives Market (Futures)	Derivatives products composed of five types of futures: i). Equity index futures; ii). Interest rate futures; iii). Middle East Crude Oil (MECO) futures; iv). DRAM futures; v). Single stock futures	The SGX Derivatives Trading Division (SGX-DT) operates 2 trading systems: the open outcry and the Electronic Trading System.	SGX-DT has become a leading derivatives exchange in Asia.	Singapore Exchange Derivatives Clearing Pte Ltd (SGX-DC) performs daily clearing and settlement, and supervises delivery of contracts. It administers the Mutual Offset System (MOS). SGX securities trading rules ensure to reflect current market practices.
Insurance	- 151 Registered Insurers - 61 Direct Insurers - 28 Reinsurers - 62 Captive Insurers - 6 Authorized Reinsurers	Insurers may conduct insurance activities in Singapore as registered insurers, authorized reinsurers or foreign insurers. S$152.8 billion	Registered insurers are approved under Section 8 of the Insurance Act (Cap 142) to conduct life and/or general insurance business. Reinsurers without an operating	The Committee on Efficient Distribution of Life Insurance (CEDLI) is appointed by MAS to improve the life insurance products. The direct general insurance brokers

		overall issuance volume	presence in Singapore can conduct reinsurance business in Singapore as authorized reinsurers under Section 8A of the Act.	adopt the *General Insurance Code of Practice and the Guidelines*, jointly developed by the General Insurance Association of Singapore (GIA) and the Singapore Insurance Brokers Association. (SIBA)

Source: Monetary Authority of Singapore (MAS).

Annex 2: Selected Issues of Market Infrastructure and Regulation in Russia

Issues	Measures to be implemented	Comments on foreign practices
Development of targeted prudential requirements for market participants, depending on their risk taking		
1. Problems with depositories, registrars and custodians		
A. Liability and buyers protection. Russia features a two-tier holding of securities model where ownership of securities is confirmed by the entries in the registries and/or depositories (appearing as nominal holders in the registry). A specific feature of the Russian securities transfer and registration system is a great number of trading, settlement, depository and clearing systems.[213] The efficiency of the registration and depository system is one of the main factors determining the finality of settlement and efficiency of securities trading. The Russian securities transfer system features the following shortcomings: 1. A lag between modernized securities legislation and the provisions of the Civil Code on protection of bona fide buyers of securities issued in non-documentary form which, as a result, causes inconsistent court practices due to the exclusion of non-documentary securities from vindication protections available to other classes of securities. 2. Insufficient rules on liability for registrars and depositories, where it is difficult for investors to demand the restoration of the records, repayment of the full price paid for a security that was later lost due to any error or inconsistency (intentional or non-intentional) in the registration system, or demand the actual losses due to such failure from the registrar; 3. The registrars and depositories are not obliged to obtain professional liability insurance as they can voluntary opt to have it. The existing practice of joint liability of the registrars with the issuer for losses caused by incorrect entries in the registry does not	-Harmonization with securities laws of civil legislation rules on protecting bona fide buyers of non-documentary securities, guaranteeing that the good faith of bona fide securities buyers is assumed, particularly if the buyer did not know about adverse issues regarding the securities at the time of purchase. Such a legislative guarantee supports market liquidity and investor confidence. - If the bona fide rights are breached there needs be a regime of rights restoration and compensation. - the liability of the registrars and depositories in cases of intentional or non-intentional incorrect entries in the system should be better defined at the legislative level; - The uniform standard of signature guarantee should be used by all registrars-participants in one system, thus enabling the verification of summary balances of authorized transactions at the end of the day. Such a system should be connected with depositories to allow for verification of securities on depository accounts with the data on nominal accounts in the registry. With transfers to dematerialized securities, a uniform electronic signature and	In the US, a registrar who registered a security incorrectly should restore the correct records at the request of the plaintiff party, excluding cases when such registration leads to an excessive number of securities versus the maximum declared in the prospectus. In this scenario an identical security should be transferred to the plaintiff, or the cost of the identical security should be repaid to the buyer with interest accumulated from the date of filing the claim. The signature guarantee program has been also in place in the US, where the transfer agents can request signature authentication from the professional market participants, and such authentication is provided in the form of a guarantee. The most popular program is STAMP which includes brokers, dealers, banks and trading platforms, who enter into compensatory agreements obligating them to compensate the registrars for the damages caused as a result of the guarantor's fault. To guarantee the compensatory payments the participants acquire an insurance policy which guarantees their financial obligations. The registrars participating in the program are required to reject transfers that do not have an original Medallion Guarantee stamp which guarantees that the individual signing the Stock Power is the rightful owner, or the authorized legal representative with capacity to sign on behalf of the owner. The Medallion Stamp may be obtained from a US bank, domestic credit union or a US registered brokerage firm. An authorized officer will sign the Medallion Stamp with their

[213] According to the data base of the Russian Association of Registrar Institutions, Russian securities transfer and registration system includes 32 registrars, 49 depositories and 20 special depositories (custodians), www.partad.ru

create a motivation for the registrars to join and develop the system of professional liability insurance.[214] 4. The length and cost of enforcing property rights in court can be substantial and add to the summary transactional costs associated with securities transfer. 5. The program of signature guarantees exists in Russia in voluntary form. However, it did not generate its full development as exists in similar indirect holding systems (in the US, for example, where the registrars are required to reject transfers which do not have a STAMP Medallion Guarantee). Although the standard form of signature guarantee agreement is developed by an SRO, the registrars can still require the physical presence of the transferor or his broker at settlement, and develop its own standards of signature guaranteeing. Even when such a guarantee is provided, the registrar can refuse to accept it and still requires all underlying documentation specified in law to conclude the title transfer.	unique security number system need to be in place for efficient trading. - Development of insurance standards and mechanisms for the guarantors and the registration system participants. - Legal amendments setting the prevalence of central depository's entries over the registry's records.	name and their title is printed below. Accordingly, a notarized signature is not acceptable by the registrar. In the US, the transfer of title to securities by the transfer agent is free of charge.[215] While guarantor firms can charge a fee for their services, they often do not, and offer them as part of their customer services.[216]
B. Infrastructure Efficiency 1. The co-existence of two parallel systems of securities rights registration, with multiple participants (client-oriented depositories and issuer-oriented registrars) creates uncertainty over property rights, as the entries in the securities registries are recognized by courts as prevailing over depositories' entries, forcing some investors to register their ownership interests with the registrar instead of relying on the more efficient trading depository system. The risk of such a system is that, even if the necessary efficiency of settlement is achieved, the load on the system may be too high with regard to other aspects (for example, corporate actions notices, safekeeping, etc.). 2. Although the Securities Law allows for electronic storage of information necessary for identification of securities and their owners' rights in registrars and depositories, paper-based documentation still prevails in Russia. The largest custodian depositories offer electronic-based document turnover, but in general transactions across the system of registrars are paper-	- According to BIS Recommendations on securities settlement systems, the recommended way of achieving efficiency would be through developing technical capabilities to meet operational system requirements of users.[217] - In order to implement the IOSCO efficiency principle in Russia, laws and regulations should allow wide usage of electronic messages for information exchange between the system players according to international standards, including lifting the requirements of obligatory paper requisites for transaction documentation and allowing usage of electronic documents and information disclosures about corporate events. - A step-by-step plan of transferring to such information exchange system, compatible with systems used in other countries (SWIFT,	In the US, where shares are issued in non-bearer form (similar to Russia), the securities registrars operate as independent legal entities and don't engage in other's activity. The registrars operate in parallel with depositories, with the first one responsible for registration of shareholders' rights, and the second one for safekeeping of securities and simplification of trading. At the same time, in many European countries, for example, Germany, Norway, Belgium, securities are registered by the central depositories, and securities registration is combined with other activities, usually, the depository. In the US and Germany, share ownership is not dependent on registration, and the transferee to hold shares in physical form is not required for share registration. However, shareholders rights can only be exercised by the registered shareholders. Because in Germany, as opposed to the US, a nonregistered shareholder of a share is entitled to receive dividends, the incentive to register is smaller in Germany than it is in the US.

[214] Resolution of the Constitutional Court of Russian Federation as of January 28, 2010 N 2-P reaffirmed the principle of solitary liability of securities issuer and registrar убытки.

[215] American Stock Transfer & Transfer Company Q&A for investors http://www.amstock.com/shareholder/sh_transferquestions.asp

[216] SEC: "Signature Guarantees: Preventing the Unauthorized Transfer of Securities". 2009 http://www.sec.gov/answers/sigguar.htm

[217] Recommendations for Securities Settlement Systems. CPSS Publications No 46

based, requiring multiple deliveries and authorizations; moreover, each group of participants has its own systems of storage for electronic documents, which raises the questions of compatibility. The information exchange among the issuers, registrars, depositories and investors includes securities transfer orders, information about new holders, corporate events notifications etc. Such a sophisticated system calls for the creation of uniform document turnover standards, using the uniform electronic messages within the system and making their electronic systems compatible.	ISO), needs to be developed and implemented under the guidance of the regulator.[218] The usage of internationally accepted standards for message formats would ease the access to the foreign investors base and would not require obligating one part of the present system to use systems already offered by another part. - To widely implement the ISO standards on the Russian stock market, the regulator in collaboration with SWIFT can identify the areas where Russian forms of financial messages are not in compliance with international standards and, based on this analysis, prepare recommendations on implementing the standards. - In addition, uniform standards should be developed for the automated systems used by trading platforms and OTC platforms. - The task of creating the uniform system of electronic messages and forms cannot be achieved solely by the infrastructure participants, given their different motivation and orientation in servicing the clients and limitations on the legislative level. The regulator should take an active part in setting the standards of the future system. - To expedite securities registration and transfer within the Russian depository system, the depositories should have correspondent accounts with each other, and use the same format for electronic message transfer.[219][220] - A single official source of information about corporate actions would reduce the system load related to various corporate events. - Immobilization or dematerialization of physical certificates in the central depository	In some countries the registrar system did not develop historically because of the tradition of bearer shares (although now they are not widely used and it is hard to restore the right if the document is lost; bearer shares are not allowed in Russia). When bearer shares enter the trading system, they should be converted at the central depository into registered shares and held there to simplify trading. Central depositories serve the purpose of immobilization of securities and dematerialization of securities, simplifying the securities' transfer between clients, depositing and writing off securities to and from the clients' depo accounts efficiently. In the US, the Depository Trust Company is the largest nominal holder of securities for its holders. DTC is a subsidiary of a DTCC which, through its subsidiaries, provides clearing, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives. The Central Depository exists in Germany and all securities traded on the German stock exchange are deposited in the Central Depository – Clearstream system. A cross-European system Euroclear incorporates central depositories of France, Netherlands and Belgium, providing a cross-border system of settlement. Currently, Euroclear is in the process of harmonization of all Euroclear group processing activity, the final stage of achieving the minimization of costs of securities settlement across the borders. In Japan the role of the central depository is taken by the Japan Securities Depository Centre established in 1984. The system performs the book-entry transfer for stocks, e.g. the computerized management (issuance, transfer and redemption) of shareholders' ownership rights, in accordance with the Act on Transfer of Bonds and Shares which abolished stock certificates for the stocks of publicly listed companies. Ukraine has recently adopted a new law on Central Depository and undertook to take measures to dematerialize all listed securities. The electronic system SWIFT is

218 Russia already started using implementing ISO codes to foreign securities qualified for trading in Russia

219 Currently, 126 companies can transfer securities between the two largest depositories – DKK and NDC, each of them assigns its own depository codes to the same securities. NDC open access data.

220 This measure is also included in the "Strategy for Financial Market Development of Russia till 2020" approved by the Government Oder as of December 29, 2008 No. 2043-p.

	should be implemented, enabling the transactions to be settled without the actual physical movement of securities. Introduction of book entry settlement of actively traded securities needs to be implemented.[221]	widely used internationally and it implies full automatic information processing for securities operations in accordance with ISO standards. In 2009 the European Central Depositories Associate has issued the Market Standard for Corporate Actions Processing, which present the uniform standards for distributions, reorganizations and transaction management. The SWIFT format is used for such standardized processing, thus providing for lower transactional costs, smaller processing time and efficient protection of market participants' rights. The consolidation of European central depositories is implemented by mergers and acquisitions or by participation in technological platforms of each other.
C. Nominal accounts for foreign depositories 1. Russian law requires a nominal account holder to be a "professional securities market participant" which should be licensed in Russia. A foreign depository currently cannot obtain a license and become a professional market participant so it cannot establish inter- depository relations with a Russian depository. 2. Settlement depositories do not fully comply with the US Investment Company Act of 1940 17f-5 and 17f-7 which prevents custody of US investment companies' assets with Russian custodians and limits custodial arrangements with Russian custodian depositories. 3. As a result, at several stages of the transaction there is a requirement to establish a custodial relationship with a foreign fund acting as custodian for his clients wishing to invest in Russian securities.[222] 4. Foreign banks which plan to do business with Russian securities often have to obtain permission from regulators to enter into a custodial agreement with a Russian subsidiary-custodian. Obtaining such a no-action letter is an additional hurdle for foreign investors, increasing overall transactional costs and fees for client access to Russian market infrastructure	The future CSD law should allow opening nominee accounts for a foreign depository in the Russian CSD, which would allow foreign investors to use the Russian infrastructure to invest in Russian securities, and allow cross-links between Russian and foreign depositories.	The US Investment Company Act of 1940 article 17f-5 sets requirements for the "eligible foreign custodian", such as the security and data protection practices, financial strength and the enforcement of US court decisions against foreign custodians (such as the existence of offices in the US or consent to service of process in the US), and central handling of securities. Article 17f-7 sets additional requirements for custodians: central handling, segregated keeping of assets of clients and others. BRIC countries do not allow the opening of nominal accounts for foreign institutions. Most ASEAN countries allow nominal accounts.

[221] CPSS Publications No 46

[222] Such arrangements include opening and licensing a subsidiary in Russia, which enters into a custodial agreement with its branch in Russia, obligating the branch to take liability to its parent custodian abroad to properly register the securities, conduct regular shares confirmations, hold shares in its name as nominee, and have its independent auditors periodically verify the share register. The arrangement may also include usage of offshore escrow accounts, letters of credits and other documentation.

D. Some implications of infrastructure inefficiency – ADR market 1. Clearing and settlement can last up to 2 weeks for direct purchases of Russian securities by foreign investors. The direct investors in Russian securities also bear the risk of bankruptcy of a Russian custodian bank or a broker involved in purchasing securities. Legal protection through the Russian courts is expensive and undesirable for foreign investors. **2.** In practice, many investors prefer to buy ADA (foreign issued securities confirming the rights to a certain amount of Russian securities), instead of RDR issues domestically. The ADAs are registered in the system of the American depository bank or by its Russian agent; the records of such depository banks have priority over the records made in the Russian registry; the ADAs are dematerialized which provides for better investor protection.	Raising capital on highly liquid foreign markets is a common practice among world's largest corporations, who also can enjoy the benefits of regulatory arbitrage choosing the best suitable countries for their ADR programs. ADR programs also help to generate the fair market value for securities and help information transparency about the actual market value, thus helping liquidity and formation of securities prices on the internal Russian market. Increasing liquidity of the domestic market can be achieved by developing infrastructure and by attracting more foreign investors to RDR market. Limiting the ratio of stocks that can be used in ADR programs by domestic issuers the way it exists now, may create certain market inefficiencies and limit the access of Russian companies to foreign investments Therefore, eliminating the restrictions on ADR issuance by domestic companies will provide better terms to domestic companies on international capital markets without sacrificing domestic market liquidity. An alternative way to boost the development of the domestic stock market would be creating a favorable climate for smaller issuers on the domestic market, increasing market liquidity and the instrument base by simplifying share issuance, registration and trading rules for smaller companies.	The British and EU initiatives on creating exchanges for average/smaller companies are of special interest here. US law provides for certain exemptions to qualified investors and also sets certain rules when the issuance of securities is not subject to registration. This can also be used as an example for a potential area of market development in Russia (also described below in the "investor registration" section).

2. Securitization		
Mortgage backed securities A. In Russia, due to the overall high cost of securitization, the market for securitized bonds or mortgage-backed securities is not active; the main reasons for this being high inflation, imperfect regulation of securitized instruments and limited access to the market of institutional investors. Given that securitization of mortgage securities allows the creation of long-term instruments available to investors on the market, the development of this sector is crucial for successful realization of banks' refinancing policies and efficient capital management. B. There are several known types of mortgage financing: sale of pools of mortgage loans; covered bonds issued by the mortgage banks or by universal banks; mortgage-backed securities issued by the banks or by specialized mortgage institutions. Russian law on mortgage securities combines two different types of securities – covered bonds (often compared to German pfandbriefer) and "mortgage participation certificates" (which have some features of mortgage-backed securities issued by specialized mortgage associations such as Fannie Mae). There are certain legal risks that can be pointed out in relation to the Russian system: - the possibility of inappropriate administration of the land registry (failure to enter mortgage information and priority claims issue); - some specialists express concern that the rights arising from mortgage liens (zakladnaya – a special type of securities) are not fully separated from the terms of the underlying contract (which raises the question of whether the legal mortgage lien and funding can be separated, and what the legal implications of title deficiencies for the validity of the loan contract are); these can potentially raise a question of validity of the mortgage lien in case of defects of the underlying mortgage; [223] - the mortgage lien transfer is not required to be registered in the state registry, but holders can still request registration of their securities in the registry, which can potentially create a different level of protection for holders appearing in the state registry vs. those who chose not to register; - article 14 of the Law on Mortgages sets forth the obligatory terms of a mortgage liens (zakladnoj). If the terms are not met, the mortgage lien	Given the early stage of market development, the government should determine whether the purpose of normative regulation in the mid-term is to build a system primarily oriented to domestic investors, or foreign investors and cross-border transactions. Depending on the chosen regulatory approach, certain legal measures can be implemented at the legislative level to help build the market infrastructure, which is most desirable for investors and provides banks with financial attractive financing of their mortgage lending activities. - the initial market structure for mortgage bonds from the viewpoint of domestic investors would probably imply that the security issue best addresses the needs of domestic investments and securities regulations. Ratings would not be a core requirement, especially by non-rated non-bank intermediaries (e.g. pension funds). The law would include the eligibility of securities for domestic repo operations, although a plain-vanilla product (absent of call options) would be preferable, with access of institutional investors to the securities provided. - for foreign investors factors as ratings close to the sovereign ceiling would be necessary, domestic security legislation and market practices must follow international standards, especially enabling trading/secondary markets in order to allow mark-to-market valuation (the key requirement for mutual funds); - there were significant steps undertaken by	Given that the Russian mortgage financing system is currently at an early stage of formation, the experience of other Central European countries (Poland, Czech Republic, Slovakia, Hungary, Poland) with similar initial conditions in building mortgage securitization is of special interest. Similar to Russia, the Central European countries were faced with problems of gaps in legal and regulatory reforms (especially the unclear transfer of mortgages or mortgage pools to investors, taxation issues, lack of enforcement, lack of necessary quality of loan servicing, ring-fencing of collateral, land register imperfections, lack of pool history). Comprehensive capital market access via residential mortgage-backed securities was not a short- term option for those countries, due to general lack of capital market development (capital market infrastructure, financial sector taxation, securities legislation, absence of securitization law, issues with ring-fencing and transfer of collateral, untested mortgage assignment). The presence of these initial conditions made the public issuing of mortgage-backed securities unfeasible resulting in aborted deals and the replacement of them by bank financing.[230] The lack of mortgage banks' infrastructure and unfavorable capital charges for banks holding mortgage-backed securities can drive the transactional cost to set up the MBS market especially high. Belgium is one of a few countries where MBS was successfully introduced. This became possible due to the introduction of the 1993 Securitization Law, which allowed for strong standardization of such deals, high credit quality guaranteed by the Flemish region, favorable domestic risk capital weighting of MBS (50 percent) and exemptions from withholding tax (Belgian institutional investors were active in the UK and the US ABS market before and were familiar with the product when it was introduced domestically). However, in the early 2000s it became apparent that traditional covered bonds (for example, German

223 Demushkina Ekaterina. "The Legal Problems of Applicability of Accessory Rights and Material Rights Protection in Relation to Mortgage Institute in Russian Civil Law". 2010

230 "Globe" Commercial Property Deal in Poland

is not considered to be valid and loses its status as a security that can be sold to the list holders. However, in practice such "defective" papers can still be issued to holders, with unclear consequences on their legal status. The law should specify how the defects of the paper can be resolved; - the mechanism of mortgage registration is not always reliable as it carries the risk of repossession by a third party while the object is being registered; or using the same assets in dual collateral fraud schemes (see further in part 3); - significant length of mortgage registration (up for a month); - duration of foreclosure process: Russian law sets the court procedure to claim the mortgaged real estate, unless the contractual recourse is provided by the agreement of parties. Even though the contract recourse is allowed, the borrower can still use the public arbitrage system to obstruct foreclosure, questioning the validity of the contractual recourse agreement or asking for postponement of sale for up to 1 year.[224] [225] Since the duration of the court procedure (up to a year) does not work for securitization, the additional guarantees such as letters of credit and bank guarantees are used in domestic securitization deals[226]; - sale of residential real estate where there is a participatory share of a child, or sale of deceased persons estates where the legal successors are not determined, can be problematic due to the existing rules on legal representation; evictions practices are not popular and not well developed; - the transfer of servicing rights to a back-up servicer is somewhat unclear; although it is possible to transfer the rights to a specialized state managing company, the order of personal data transfer, bank secrecy rules, applicability of capital gain tax to such a transfer is not defined, raising potential issues of length, accuracy and amount of loss incurred during the transfer period; - the lack of clarity of the procedure of issuance of mortgage participation certificates and the somewhat cumbersome procedure for collateral management and securities registration does not enable the issuance of such instruments; to date, there were no issues of such	the Russian government to assist the turnover of mortgage securities (such as the introduction of depository storage of securities and draft amendments to the Law on Mortgage Securities prepared recently by FFMS). Further legislative development for this type of transactions will depend on successful development of collateral rules (see section on collateral below), and of construction and land legislation; - some of the indicated legal risks will be mitigated as more legal practice is accumulated and automation of processes (land, securities registries) takes place. Others will require amendments in existing legislation, depending on the chosen structure. For example, widening of the range of institutional investors allowed into the market, measures simplifying and clarifying the issuance of mortgage securities, flexibility in choosing the tranche scheme, and introduction of escrow accounts.	pfandbriefer) were a niche market for investors with domestic buy-and-hold investors. In Germany the traditional pfandbriefer market, due to its low liquidity (the trade-off of no-call provisions – interest rate binding maturities desired by borrowers which may shift), has increasingly become replaced by other funding sources, such as retail deposits. In 1999 in Germany mortgage bonds funded approximately 15 percent of new mortgage loans. Securitization through true sale of investment schemes became an important part of the business models of certain banks and other specialized lenders (S&P, 2003). Securitization deals involving the sale of portfolios of commercial and/or residential properties using SPVs outside Germany (and often for non-German asset pools) became popular (due to an unfavorable tax regime in Germany for SPVs and unclear insolvency law with regard to transfer of assets/collateral). Some steps to develop the domestic ABS brand were also undertaken: the so called "True Sale Initiative" by KfW is one of the best known. It had the purpose of defining accepted standards for ABS-issues, and in creating a common infrastructure in Germany for TS securitizations, and to encourage the change in the respective legal framework and to define and implement quality and pricing standards for liquid ABS issues. The domestic initiative was aimed at allowing small and medium-sized domestic banks with no access to foreign markets to use the efficiencies of structured finance techniques. Since the insolvency law did not provide direct carve out rules for such transactions, the German Donation Law was used to create the insolvency remoteness of the owner.[231] The first ABS in Germany via German SPV "Drive One" was done in 2004 (110, 000 consumer loans from Volkswagen Bank to the amount of 1.2 billion Euros). According to S&P data, some of the largest European banks

[224] Article 51 of the Law on Mortgage

[225] Aricle 54.3 of the Law on Mortgage

[226] The investors can also face with difficulties claiming collateral of land parcels and adjoined buildings when such parcels were joined to the building after the deal took place. For example, in one case the court resolved that, since the building could only be sold together with the land plot, and the land was not included in the list of collateral when the creditor purchased securities, the investor cannot have a recourse against his collateral, the building.

[231] Presentation of KfW "Why Securitization of increasing importance for Germany as a Financial Center"? Frankfurt; ILF; 02.18.2005

certificates due to the unclear legal structure; - bonds are often placed among a limited group of investors or repurchased by a company affiliated with the originator; - there is a risk of insufficient isolation of cash flows designated for SPV securities holders within the bankrupt institution where the SPV has an account due to the lack of the escrow accounts concept; - disclosure: standardization of borrower disclosure (like annual percentage rate of charge – APR) is important for reducing potential risks of defaults in mortgage collateral by assisting the borrowers to make educated investment decisions, but such standardization is not yet introduced; disclosure of prepayments types to the issuer (refinancing or sale); - partial prepayment of covered bonds is allowed.[227] In other countries, the loan prepayment can be effected based on economic factors, such as prepayment of underlying loans by borrowers in case of interest rate fluctuations. In the case of Russian covered bonds the prepayment calculations are not tied to economic factors (borrower repayments), which can result in the practical impossibility of investors trying to forecast the yield curve for such instruments; - prepayment by the borrower of mortgage loans is allowed in Russia but can be mitigated by prepayment fees, prepayment moratoriums (up to 6 months) and by issuing securities with shorter maturities (it seems that it is possible to fix a minimum five no-prepayment terms or charge a prepayment penalty, which would allow better pricing modeling of long-term instruments but it is not used due to the short-term nature of the market). [228] - lender options allow certain flexibility in managing the pool of collateral. The assignment for Russian "covered bond" collateral is determined by the pledge of rights of securities holders: t he pledged assets cannot be assigned or transferred without the bond holder's consent. The right of pledge provides for best control over the collateral, which can be achieved within the framework of the current law, but at the same time this somewhat limits the flexibility of collateral management by the issuer; - currently institutional investors' ability to invest in mortgage-backed securities is limited which reduces the demand for such securities domestically. For example, insurance companies are required to		increased the percentage of their on-and off-balance sheet funding by up to 30 percent (Centro-leasing, Agos Financing in Italy, Bancinter in Spain). Regulatory capital relief, reduction of economic capital requirements and risk diversification were the main drivers for this type of securitization. The economic crisis of 2007 has shown the shortcomings of the MBS type of financing. In conditions of crisis, the issuance of covered bonds became paramount to guarantee the necessary level of investor protection (contrary to MBS, the guaranteed pool of assets remains on the bank's balance sheet, giving the holders of covered bonds the potential right of recourse against other assets of bank-issuers in case of insolvency). In countries such as Canada and Australia the segment of covered bonds is rapidly growing, creating further incentives for governments to create appropriate local laws and regulations for such bonds. Along with the growth of the covered bond sector, the rules for MBS types of securities are becoming more rigid. For example, the ''Dodd-Frank Wall Street Reform and Consumer Protection Act'' introduces new rules for riskier mortgages ("Non-Qualified Residential Mortgages) requiring the sellers of such mortgages (so-called "originators") to retain ownership of 5 percent of the loans in order to align the interests of the sellers with those of the investors. Provisions on capital relief are also under reconsideration. In Russia the issuance of mortgage-backed securities reached it pre-crisis peak in 2007 of approximately RUB70 billion) and fell to less than RUB30 billion in the second half of 2011.[232] This raises a question of creating conditions for financial instruments which best meet the refinancing needs of banks and address the new post-crisis investor expectations for such transactions.

[227] Article 12.3 of the Law on Mortgage Securities

[228] Article 315 of the Civil Code of RF; Article 17.4 of the Law on Mortgage,

maintain a level of capital allocation at a maximum of 5 percent for mortgage-backed securities.[229] Overall, domestic institutional investors have not yet implemented the internal methods of pricing and risk-based capital allocation for such instruments - the law requires absolute seniority of tranches where senior securities are repaid first, before the next senior tranche, proportional repayment of tranches is not allowed, limiting the issuer's flexibility in managing the income and repayment flows.		
B. Tax aspects of securitization The structure of securitization should provide guarantees that parties involved in transactions are not subject to excess tax obligations. In Russia the tax consequences of securitization are often unpredictable, with each stage of the transaction potentially having tax consequences. For example, VAT can be potentially applied to a "true sale" portfolio; or the "over-collaterization" often used in securitization may have profit tax implications; the movement of funds to compensate the SPV for its management may also realize tax gain. Assignment of receivables is subject to profit tax. The law does not allow recognizing as expenses selling of assets with a discount, and, consequently, this does not allow to reduce the tax base on the profit tax. For tax planning purposes, the SPV should be usually set up in a jurisdiction that has a special tax regime for securitization, and/or the profit tax is minimal.	In order to make the domestic market more attractive for securitization deals, a few initiatives can be taken on the level of tax legislation: - the types of income that can be tax free if the SPV is a source for such income should be clarified (the Law on Mortgage Securities introduces the special tax status of SPVs for mortgage securities, but other classes of assets are not covered by that Act); - elimination of VAT for servicing fees, - special tax regime for the issuer, - development of rules on taxation asset transfers, including future receivables; - tax aspects of creating the reserve fund; - taxation of assignment of rights between the originator and the SPV; - tax determination letters are used in Russia, but their disclosure, and time required for obtaining may be problematic	In some European jurisdictions, the SPV enjoys minimum taxation: a possible tax exemption may be available for interest received by investors that purchased the pfandbriefs -- part of the commission is not subject to taxation. Creating the permanent representation of the issuer during servicing of the loan can cause the VAT being charged at the source of payment (SPV). Ireland and Netherlands are considered as the most tax friendly jurisdictions to set up the SPV. In addition to being a party to many double taxation treaties, Ireland also has special legislation which regulates special taxation of securitization deals which creates very high level of legislative transparency for such deals. Normally, the SPV is not subject to VAT, as management serves are VAT exempt. Netherlands has developed a practice of issuing preliminary tax rulings for future transactions, which also adds confidence regarding consequences of securitization. The VAT is applied on case by case basis, depending on specifics of SPV activity.
C. Securitization of other types of assets. Securitization transactions with other classes of assets are known to Russian practice (factoring deals, auto loans, etc.). These types of securitization allow banks to refinance not only mortgage loans but any class of other receivables, thus allowing for better asset and liability management. In practice, most of these deals are "trans-border" transactions, where Russian assets or legal rights are used as the base asset, the SPV is set up abroad, and the receivables are created in hard	The necessity of the introduction of a large number of new legal norms raises a question of legal technique for such regulation. Some experts describe a need for a Law on Securitization, others stand on amending the various branches of civil law, tax, securities and corporate law. One of the difficulties	Most securitization deals in Eastern Europe and CIS countries are structured as "true sale" transactions. Due to the low credit rating of servicing agents (SPV) working in Eastern Europe, mechanisms such as over-collaterization, options, bank guarantees and political risk insurance can be used to reduce those risks and guarantee the steady flow of payments to the investors by the SPV. In many developed countries with a long history of securitization the definition of securitization is not provided

232 data from Rusipoteka http://www.rusipoteka.ru/rejting_ipotechnyh_bankov_i_ipotechnyh_kompanij/

229 The Order of Ministry of Finance Number 100N

currency abroad. This is used to mitigate the political and legal risks. Among such risks can be: the potential insolvency of the credit organization/originator and inclusion of the collateral in his bankruptcy coverage; complicated rules on access to collateral by lenders/bond holders; rules on access of the bond holders with the variety of cases when the bankruptcy crisis manager can seek to make securitization void; lack of provisions on escrow accounts, imperfections of collateral legislation (e.g., limited range of assets that can be used as collateral, see part 4 below); potential tax consequences of the securitization transaction; insufficient norms on assignment of future receivables (unclear status of the assigned receivables in bankruptcy, possible inclusion of the assigned receivables in liquidation; lack of clarity on assignment of future receivables not individually defined in the contract); a lack back-up servicer regulation, etc.	associated with having the Law on Securitization is the complexity of regulatory objectives, and the large variety of possible transactions complicating creation of a uniform regulation for all possible securitization-type transactions. This should be evaluated and weighted while developing the approach to regulating securitization deals. The new regulations should provide conditions for applying the existing international standards (for example, ISDA master agreements for credit default swaps; the United Nations Convention on the Assignment of Receivables in International Trade)	in the national law but instead is developed by court practice. Many detail of the future deal can be set forth by the company's charter, which provides greater flexibility for business practice. At the same time, developing countries have laws on securitization (South Korea, Pakistan). Most of those acts have as a purpose to define the "true sale" as a condition allowing segregating a securitized portfolio from other assets of the debtor in the case of insolvency. In the US a general definition of the true sale is provided in Section 541 of the Bankruptcy Code. The main criteria for the "true sale" test are the transfer of the rights to profits and rights of disposal, a risk transfer and no conditions on a portfolio back transfer. However, all true sale conditions cannot be fully described in legislation; instead, they are interpreted by the courts. Generally, in order to recognize a true sale, the court would consider the following factors: 1) whether the investors in an SPV have the right of recourse against the assets of originator; 2) who controls and manages the portfolio after the transfer; 3) the fair market value of the sale price; 4) the intent of the parties to sell the portfolio to the SPV. There is no uniform legal practice yet in qualifying the true sale deals across countries: many countries follow US rules, but even in the US, courts in different states have different practices. In most countries where the securitization deals became popular, the income generated by collateral is protected in "escrow accounts". The accounts are immune from recourse of other creditors of the bank/issuer, as well as from being frozen by tax authorities or collection agents. Even the issuer cannot make any decisions with regard to this income or redirect this.
3. Collateral Rules		
A. General issues with collateral Collateral rules are one of the main indicators of financial system development: without flexible collateral rules the opportunities of business participants to enforce their lender/borrower rights, and to obtain financing through a wide range of deals and diversify portfolios, are substantially limited.	The range of existing problems with regulation of collateral covers various classes of assets and rights, as well as registration, management and enforcement issues. The magnitude of legislative gaps calls for collateral rules reform, which would take into account the best foreign practices. The future	The rules on collateral in the US are governed by Article 9 of the Uniform Commercial Code (UCC). It applies essentially to all tangible property (e.g., goods) and intangible property rights (e.g., payment rights and other rights). Article 9 does not apply to real property (mortgages) and some non consensual liens due to court orders. The law sets a few conditions for collateral to be

Russia's collateral rules were assigned a score 3 (out of 10 possible scores) by the World Bank Group "Doing Business" report, indicating an acute need to reform legislation in this area.[233] Collateral rules are still lagging behind foreign systems, having a number of problems: - A class of liabilities having one common feature cannot be secured by collateral: each liability/obligation must be individualized. As a result, every time a liability changes, the amendments need to be made in collateral documentation. Similarly, liabilities which change over time or revolving credit lines cannot be efficiently secured by collateral as the contractual obligations cease when the borrower repays the revolving line at some point. As a result of such limitations, securing changing financial obligations requires constant amendments in collateral documentation, when these change over time. - limited range of assets and rights that can be used for collateral, for example, the enforceability of security over money deposited on bank accounts remains unclear. Although the market has developed the concept of a pledge of rights against a bank, it remains largely untested by the courts. Pledge of rights is relatively new to Russian law in general, raising the question of possibility of using this type of collateral in securitization transactions, and enforcement and taxation. For example, in relation to bank deposits, the rules on valuation, public auction and location description should not apply; - the requirement of individual description of assets provided as collateral; - unfavorable taxation rules for collateral sale: the total cost of the sold collateral is subject to VAT, which does not allow the creditor to receive the cost of the pledges property/rights back (this will add more on top of expenses for enforcement of collateral); - cumbersome collateral registration, the uniform collateral registry with index of assets by type is not in operation; - the risk of mixing of pledged assets with other assets of the debtor: the pledge rights can be ceased as a result; - the security cannot automatically extend to future of after-acquired assets or extend automatically to its products; - secured creditors do not have absolute right to their collateral outside bankruptcy procedures; - for pledge of rights, the transfer of the pledged rights to the creditor in	changes should also provide for certain contractual freedom to determine the terms of collateral and the events of default	secured, such as providing value, entering into a security agreement, and possession (also depending on the type of collateral,). Once these terms are met, the collateral acquires protection from third party claims ("perfection"); and filing is not required if collateral is in possession of a secured party, e.g., for securities or money. The protection is continuous regardless of the method by which it was acquired. In case of default or insolvency, priority over unperfected creditors is given to those who are first to file or to perfect their security interest in the collateral. A default triggers a secured party's right to repossess and sell its interest in collateral, and usually the contracts contain provisions which will trigger the event of default. A creditor seeking sale of collateral should follow requirements on: 1) presenting a signed notice to the debtor and other interested parties about the upcoming sale which should be sent at least ten days before the sale; and 2) a commercial reasonable sale. The fact that a greater amount of money is involved with the sale compared to the size of collateral will not establish that the sale was unreasonable. It is commercially reasonable if the sale is conducted in the usual manner for collateral of this type. In the US there is no unified collateral registry in operation. The US is ranked 8 out of a possible 10 score for creditor's rights protection by the World Bank "Doing Business" report. Several Eastern European countries used the US model for their collateral rules. For example, Romania (rated 8 out of 10 for its legal rights protection available to creditors by the World Bank "Doing Business" report) has its own Security Act inspired by Article 9 of the US UCC; Security interest can be obtained over essentially any type of assets, including deposit receipts, accounts receivable and future sales, and security over specific movable goods and universality of movable goods. In order to secure collateral over intangible goods a notion of "fond du commerce" was introduced, which also means universality of intangible rights that a company needs in order to conduct business (the clientele, the capacity to make money, trade marks, stock, licenses etc.). The re-possession of collateral in

233 "Doing business 2011. Russian Federation. 2011 The International Bank for Reconstruction and Development / The World Bank Group

cases of breach of the contract is not allowed (due to the conflicting rules of Civil Code and the Law on Pledge); - the law authorizes parties to agree to out of court enforcement, however, there is little experience of out of court enforcement of collateral in Russia, so the efficiency of such procedures is not always predictable. **B. Issues with collateral pertaining to securities.** **-** the procedure of repossession of the stocks-in-trading by the lender is not clear; - depositories are not allowed to engage in securities transactions without orders of the depo accounts holders. In case of repo transactions, when repossession of collateral is demanded by one party in case of another party's failure to meet obligations, an additional order from the borrower to the depository is required in order to start the repossession. **C. Mortgages.** - in the absence of a contractual agreement for out of court recourse, the foreclosure process can be lengthy (more than a year, if the borrower does not agree with repossession); - the rules on mortgage of land parcels which were joined to the mortgaged buildings after the mortgage contract is signed do not favor the creditors (the existing court practices refuse the repossession if the pledger did not have the ownership title to the land at the time of placing the mortgage lien); - the requirement of an individual price indication for each real estate object in the mortgage agreement for "pooled" mortgage agreements: the repossession cannot be effected in relation to the portfolio if individual prices are not indicated.[234] - repossession of collateral in case of default is lenghtly (more than a year if the borrower does not agree). The law allows contractual (out of court) procedure for repossession, but in practice the procedure does not work (borrowers can file a suit to invalidate the contact, rarely agree to contractual recourse condition).		default requires 24 hours notice; the time limit can be extended to 2 weeks if the debtor disagrees. All notifications are centralized by the Electronic Archive of Security available on internet for no fee, which enforces the protection against third party claims. The UK is ranked 9 out of 10 by the above mentioned WB report. This country has a flexible system of "floating charges" (applied to assets which cannot be repossessed by the borrower without a lender's permission thus giving more flexibility to manage the business) and "fixed" charges (applies to collateral which can be repossessed, like stock-in-trading, amd also gives a stronger hold for the lender in case of default vs. a floating charge). The law provides for a uniform collateral registry. The future money flows, businesses as a whole, stock-in-trade, groups of assets, book debtors and other fluctuating assets and assets acquired after the floating charge was formed can become collateral. The terms of the contract and common law specify the event of "crystallization"- the event when the borrower's freedom to deal with the assets is frozen. Among such events, are the borrower's liquidation, appointment of a receiver, intervention by the Lender according to the terms of the contract. According to the Insolvency Act 1986, any proceeds realized from assets secured by a floating charge must be used to pay any preferential debts of the company first, before meeting claims under the floating charge. The main preferential debts are limited to outstanding employees' wages and pension scheme contributions. The failure to register the floating charge results in invalidity of the charge against administrators and liquidators and loss of priority over other creditors (even in case of third party notice), and the loan becomes immediately payable by the borrower. It is an obligation of the borrower to register the charge, and penalties can be assessed in case of non-compliance.
4. FX controls –Conversion, repatriation of funds		
The reserves and related regulatory requirements for FX were eliminated in 2007, making it possible to effect FX transactions between	- Although many restrictions were lifted by the 2005 changes to the currency control law,	In Hong Kong which is a small and open economy with a Linked Exchange Rate System (LERS), where the Hong

[234] Resolution of the High Arbitration Court No. 13188/07, 2007.

residents and non-residents without formal restrictions. Starting June 18, 2005 Russian legal entities –residents were allowed to open accounts in foreign banks without Central Bank approval. Foreign currency operations between residents are prohibited, expect for those explicitly allowed by law, for example, loans denominated in foreign currency are not allowed; but the currency operations between non-residents are allowed without restrictions if this relates to cross-border operations or operations through special authorized banks; foreign residents scan transact in Russian and foreign currencies through accounts opened at authorized banks; though the foreign currency operations between Russian residents' accounts abroad are prohibited. The currency exchange limitations were abolished. Non-residents are allowed to settle securities trades in Roubles or US dollars. While residents are allowed to buy foreign securities through professional participants of stock market, the settlement in foreign currency is not allowed, which forces the traders to finalize settlements abroad. The rules on control and registration remain in force. Resident legal persons are authorized to open accounts abroad subject to a notification of tax authorities in Russia. The preliminary registration of accounts by the tax authorities and registration of the export of Russian currency and securities is made by the regulator (this can take up to 10 days). Non-residents are authorized to open accounts in Russian or foreign currencies in authorized banks; and freely transfer foreign currency between their Russian and foreign accounts -- the law does not specify whether domestic currency could be freely transferred to non-residents' accounts abroad. There is an obligation for residents to repatriate the revenues received abroad from foreign commercial activity to Russian bank accounts. The currency lending transactions between a resident and a non-resident must be accounted for by the Russian party by means of submitting a 'passport of the deal', a document prepared for each contract, and a 'transaction statement', prepared for each incoming or outgoing payment. Forms of the documents are regulated by the Central Bank. The reporting is usually done by the banks on behalf of customers. The authorized banks act as agents of currency control, and can request a list of documents from residents and non-residents before processing a currency operation: the underlying contract, data about status of a non-	the reporting and registration requirements are in force, and there may be some issues with practical implementation by the currency control agents (authorized banks) of these requirements in terms of documentation and timeline. - subject to these requirements, the regulation for non-residents seems to be adequate; at the same time, foreign currency operations are still problematic for residents. Currently the law has an exhaustive list of allowed currency operations: having an open list of allowed currency operations for residents would provide them more freedom for doing business with foreign counterparts; settlements in foreign currency should be made available to residents; the same applies to payments and transfers in foreign currency between professional participants of the securities market. - according to market participants, there are still issues with implementation of the new rules by authorized banks; therefore, some efforts need to be made by the respective regulators to provide for effective implementation of the new rules. - exchange control limitations on settlement in foreign currency may result in unnecessary conversion costs if the settlement is done domestically. As many foreign investors operate in the Russian market through their subsidiaries, which have licenses of professional market participants and are treated as residents for currency control purposes, the rule affects indirectly foreign investors operating in the Russian market as well.	Kong dollar is linked to the US dollar, and an international financial center with some of the major international financial institutions participating in the local interbank market, there are no exchange control restrictions on residents or non-residents, and funds can be freely repatriated. Non-residents can open accounts in local or foreign currency, no underlying securities trade is required to purchase local currency, overdrafts are allowed, and there is no withholding tax or capital gain tax on any financial instrument. Japan does not have any market entry requirements for foreign investors or investor registration requirements. The yen is fully convertible, there are no foreign exchange restrictions, sale proceeds or income from investments can be freely repatriated, foreign investors can freely open cash accounts in yen, and credit balances are allowed. In most Asian regional financial centers, internationally recognized securities numbering and SWIFT message formats are used, and the securities held in the central depositories are dematerialized. Most countries do not have any lock-up periods for repatriation of funds. The largest regional financial centers (Japan, Hong Kong, Singapore) do not have restrictions on and cash balances and overdrafts for foreign investors. At the same time, some of the countries (Indonesia, China, Korea, Malaysia) limit the amount of overdrafts available to foreign investors or restrict them to certain types of securities trading transactions. Overall, the regional financial centers are characterized by low entry and exit costs for foreign investors

resident legal entity and its registration data, the custom documentation if applicable, and a passport of a deal. According to the law, the authorized bank can request only information which is relevant to the transaction in question; and the documents should be translated into Russian and legalized. According to the terms of servicing contracts for foreign currency accounts established by the depositories, stock trading requires opening of a main account and a corresponding trading account in US dollars; the client's orders are executed within the limit of currency on the main account. A similar approach is used on the term market (a reserve of foreign currency in required on the depo account corresponding to the trading account). Foreign residents can also open national and foreign currency accounts in Russia (the list of documents required to open the account includes the charter documents, the application, and the requirements to open the account are generally reasonable). Generally, overdrafts to foreign residents are not prohibited, however, it has to be confirmed that they are widely used by investors in securities trading due to the specifics of the depository settlement rules. The largest depositories in Russia offer their clients settlement services in US dollars through Euroclear and Clearstream systems. The settlement is subject to the rules of the foreign depositories on settlement and transactions as related to corporate events.		
5. Investor Registration and Market Access		
Issuers and investors are faced with multiple-step lengthy securities issuance and registration processes when trading on the Russian market. Recently, the definition of qualified investors was introduced in Russian law. However, its practical implementation lacks the meaning usually attributed to this notion in western markets (an opportunity to obtain exemption from registration status for securities offered exclusively to qualified investors). According to article 27.6.5 of the Securities Law, the securities may only be offered to qualified investors after the registration of a prospectus. In other jurisdictions, private placements, offerings to institutional investors and small offerings are granted "exemptions" from registration, including those under the U.S. federal securities laws. It appears from the Law on Securities regulation that non-public issues to qualified investors are still considered as "issuances" which are subject to a state registration prospectus.	The securities registration requirements can be further simplified; the report on the results of the offering could be excluded from the list of filings for medium size and small issuers, when a professional intermediary (an investment bank or a financial consultant) is involved in the preparation of the prospectus; some types of offerings may be excluded from registration requirements similar to exclusions existing in other markets; the concept of restricted securities needs further development in terms of offerings to qualified investors as well as small offerings. The offering of securities through	In the US, Securities and Exchange Commission has taken measures to unify and simplify the standards for financial reporting in securities registration documents and reporting. In practice, registration and reporting is now performed according to the forms issued by the Commission, and their content is practically identical, which significantly reduces the time and costs of securities issuance. The US system provides for a distinction between "public" and "private" placement, with the latter giving investors and issuers more flexibility in accessing the market (registration rules are not applicable to private placements); however, the US legislation does not sacrificing investor protection at the same time, providing for necessary guarantees for securities buyers. The US Securities Act as of 1934 requires that all

In addition, as described in the section on the "Registration System," notwithstanding the substantial development of legal standards governing security transactions over the last few years, title registration procedures applicable to shareholders remain legally and technically cumbersome, particularly for non-Russian shareholders.	underwriting institutions should be simplified, subject to underwriter's guarantee to buy back the undersubscribed offering.	securities offered to the general public must be registered with the SEC, unless an exemption applies. There are three exemptions: intra-state offerings, small offerings (regulation A) and private placements where securities are not solicited to the public and are offered to qualified investors (regulation D). The exemption of an offering does not mean that the issuer need not disclose information to potential investors. Instead, the issuer supplies essentially the same information in the private placement memorandum, as opposed to a prospectus for a public offering. The distinction between a prospectus and a memorandum is that the latter does not include information deemed by the SEC as "nonmaterial" and is also not subject to SEC review. Private placement also implies less periodic disclosure has to come up at the trading platforms intended to facilitate re-sales of unregistered securities, between institutional investors and the settlement of those securities (e.g., GS TRuE, PORTAL Alliance).
Non-residents, as a rule, are allowed to buy shares of Russian companies. However, the stock ownership in state oil and gas monopolies and insurance companies is limited for foreign investors (for example, the share of non-residents in the share capital of insurance companies should not exceed 25 percent). Since a significant amount of the listed shares are issued by the state monopolies, this present a real limitation for participation in Russian stock market for non-residents. Non-resident entities are not allowed to trade directly on the stock market (this may only be done through stock-exchange members or custodians which hold securities). For trading, securities owned by a non-resident must be held on trading accounts (sub-accounts) opened for a certain stock-exchange in the Russian settlement depository which provides settlement services for the stock exchange (NDC or DCC), for which cash for trading must be deposited in the account of a foreign depository or its broker/custodian with settlement banks used for the stock exchanges. Each foreign client of a stock exchange member is assigned a specific number. In order to open an account at a depository, foreign entities must present a set of standard documentation, which should be legalized and contains the trade registry certificate, a certification on incorporation, copies of the charter documents, a certificate of	The market regulator can consider simplifying access of foreign investors to the market, such as providing easier access for foreign financial institutions to the Russian market subject to condition of clearing the transactions through a Russian licensed clearing agent and/or opening the nominal accounts with Russian depositories. Such efforts, combined with the efforts of creating an integrated securities registration and transfer system (similar to either the European or the US model) that is linked to the foreign custodial and settlement systems, would bring the Russian system in line with practices used in other global financial centers. An integral part of being an international financial center is efficient inter-depository cross-border relations, through the system of correspondent accounts in foreign depositories. The move to standardized electronic information exchanges which is already in use by the foreign central depositories (as described above in the	In Hong Kong, Indonesia, Japan, Malaysia, Singapore, and Thailand, there are no foreign investor registration requirements. In most ASEAN countries mild investor registration requirements are in force: investors have to obtain a unique ID or a trading code (Korea, Vietnam); registration may be required for repatriation of funds (Philippines); and notarization is required for opening custodian accounts (Thailand). Among all ASEAN countries, China has the strictest requirement for foreign investors, issuing investment quotas and requiring obtaining a qualified investor status to trade.

registration with Russian tax authorities and a bank account confirmation. Foreign legal entities cannot become direct participants of clearing houses, as the application documentation requires a banking license in order to be accepted in the clearing house. At the same time, the largest western banks have subsidiaries in Russia with such a license, and they do participate in clearing houses. Since foreign depositories' activity is restricted to beneficial owner accounts only, the custodial arrangement between a foreign bank acting as a custodian and its licensed branch in Russia are often used, i.e., there is a need for a wholly-owned affiliate having a credit license in order to fully engage in investment activities on the market.	section on "issues with depositories") will help establish such relations and easier access to the Russian market for foreign investors.	