ORDER FROM DISORDER: THE DEVELOPMENT OF THE RUSSIAN SECURITIES MARKETS

J. ROBERT BROWN, JR.*

Last year was the year of expectations. This year is the year of disappointment. Next year will be the year of reckoning.1

1. INTRODUCTION

Vasiliev's words summed up the process of legal reform of the Russian securities markets since the onset of privatization in 1992. These words amounted to stark recognition that effective and organized markets would emerge only when participants were sufficiently ready for such advancement. In many respects, this required a period of disorganization and abuse, with the abuse itself fostering an environment of reform. The Russian securities markets were abuse ridden

* Associate Professor of Law, University of Denver College of Law; J.D., 1980, University of Maryland Law School; Ph.D., 1993, Georgetown University; Advisor, Russian Federation Commission of Securities and Exchanges, 1993-94. I received a number of comments on the draft. In particular, I am indebted to the comments of Dominic Sanders, a partner at the British firm, Linklaters & Paines, who has handled complex legal matters in Russia since the early 1990s. In addition, I received excellent comments from Celia Taylor, a Professor at the University of Denver College of Law. Finally, I want to thank the efforts of the Pennsylvania Journal of International Business Law in editing and citechecking the article in a short period of time. I would also note that portions of the article were based on personal observations made during my stay in Moscow and obviously were not susceptible to independent verification by the Journal.


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and disorganized. No central trading markets existed. Participants operated in an environment devoid of useful information. Managers and outside shareholders had an antagonistic relationship, with constant conflict the norm. Operating companies seeking to raise capital had to compete with businesses running flamboyant television commercials and promising 3,000% returns.

Views emanating from the west, particularly the United States, suggested that the problems be corrected through legal reform. In other words, the problems resulted from an inadequate legal infrastructure. With the possible exception of crime, therefore, the absence of an adequate legal regime amounted to the most common explanation for the economic morass confronting Russia and for the dearth of much needed foreign investment.

Unquestionably, Russia had a flawed legal infrastructure. The radical shift from a centrally planned economy to a market economy necessitated a legal regime that would account for the new dynamics. In many instances, laws were

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2 The efforts at legal reform resurrect the debate between the law and development movement in the United States and the efforts to export legal norms to other countries. The United States had attempted to use legal norms in an effort to "modernize" third world countries. These efforts were criticized for not sufficiently taking into account the underlying sociological, institutional and economic factors that existed in these countries, factors that modified the effects of the legal regimes. See generally JAMES A. GARDNER, LEGAL IMPERIALISM: AMERICAN LAWYERS AND FOREIGN AID IN LATIN AMERICA (1980); see also David M. Trubek & Marc Galanter, Scholars in Self-Estrangement: Some Reflections on the Crisis in Law and Development Studies in the United States, 1974 Wis. L. Rev. 1062.

3 See, e.g., Remarks by Ambassador Thomas R. Pickering, U.S. Ambassador to Russia: At the Four-Day Conference, Making Trade and Investment Work: Financing, Kremlin Int'l News Broadcast, Oct. 12, 1994, available in LEXIS, World Library ("Today, crime and corruption are major impediments not only to foreign investment but to native Russian economic enterprises as well.").

4 See id. (noting that economic problems were in part a result of "the absence of legislation in many areas which are necessary to define an effective and functional and orderly business relationship, the primary example being that it's extremely difficult, if not impossible, under current circumstances, to enforce contracts . . . "). In fairness, the calls were not just for legal reform but also for increased enforcement.

5 This article does not address the more fundamental question of whether the "open market" model was appropriate. The case has been persuasively made that countries in a developmental phase may opt for a model that tolerates a much higher degree of government intervention. See CHALMERS
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hurriedly put into place without adequate thought or analysis. The problems that developed, however, did not arise from flaws in the legal regime but from the underlying dynamics within the Russian markets.

The development of the Russian securities markets illustrated the limits of legal reform as a solution to the country's economic problems. Through privatization, Russia embarked on a deliberate effort to shift towards a market economy. Most privatized companies were unprepared for what followed. While the rules of management changed, management itself did not. Privatized companies were overseen by the same directors that had managed them during the days of central planning. Neither the firms nor their former management were equipped for the transition.

Predictably, management had a negative, if not hostile, attitude towards outside (non-employee) shareholders. These investors purchased shares with vouchers, obtaining an equity interest without putting any capital into the companies. They agitated for dividends and other forms of return, something unpopular in cash-starved, often inefficient, companies still coming to terms with the rigors of the private sector. The relationship led to a variety of abuses in the corporate governance area and battles for control between management and the outside shareholders.

Ill equipped management was not the only problem. Companies were expected to resort to public markets for their


In the corporate area, the development of a model charter for privatized companies is the best example. See MODEL CHARTER ON AN OPEN JOINT-STOCK CO. (State Comm. of the Russian Fed'n for the Management of State Property, 1992), translated in 2 PRIVATIZATION MANUAL doc. E-2, 1, 10 [hereinafter MODEL CHARTER]. The charter contained numerous inconsistencies with the Statute on Joint-Stock Societies, SP RSFSR, Issue No. 6, Item 92 (confirmed by Decree of the RSFSR Council of Ministers, No. 601) (Dec. 25, 1990) [hereinafter Regulation 601], the provision governing corporations. See infra notes 25-39 and accompanying text.

This article does not maintain that legal reform is irrelevant or lacks significance. In fact, in some areas, legal reform must continue. For example, Russia lacks any law on intellectual property and needs a more rational corporate tax system. The article, however, argues that many of the obstacles that have hindered Russia's efforts to shift to a market economy, particularly in the area of capital markets, do not lend themselves to legal solutions.
capital needs. They found, however, that the markets were underdeveloped, disorganized, and not otherwise up to the task. Broker behavior was almost entirely unregulated, with no requirements for reporting stock transactions, no restrictions on the disclosure of mark-ups, and no general principles of investor protection.

In addition, companies did not disclose meaningful information about their operations. Little trading occurred on an inter-regional basis, making national offerings difficult. Public offerings, therefore, had to resort to loud television commercials and promises of exorbitant returns to attract the requisite purchasers, with MMM the most notable, but far from only, example.

Efforts arose to "correct" the abuses through legal reforms. Presidential decrees addressed the improper use of the shareholder registries and the problem of hyperbolic advertisements. Large companies were required to include outside directors on the Board. Agitation occurred for a comprehensive revision of the existing corporate law.

The reforms rarely had their intended effect. This occurred in part because of the inadequate consideration given to the underlying dynamics of the Russian securities markets. Some of these dynamics were bureaucratic. In the securities area, for example, the Ministry of Finance, the primary agency authorized to oversee the markets, had proved resolutely unwilling to exercise effectively its authority. Simply giving the Ministry additional power, therefore, did little to advance the desired results.

Moreover, given Russia's history of central control, adopting legal reforms designed to increase governmental control of the markets meant greater intrusion into the

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8 Reliance on the capital markets was not the only potential solution. Japan confronted equally dire straits following the Second World War. Rather than turn to the equity markets, Japan used debt financing through private banks as the primary mechanism for funding capital needs. This approach succeeded in minimizing foreign ownership and in increasing government control over the development process. See J. ROBERT BROWN, JR., OPENING JAPAN'S FINANCIAL MARKETS (1994).

9 The demise of MMM in July 1994 affected an estimated 5 million shareholders. In a two-week period, shares of MMM were worth less than one percent of their pre-collapse price. See Stock Fund Collapses in Panic, Facts on File World News Digest, Aug. 4, 1994, available in LEXIS, News Library.
markets, a cure worse than the ailment. Government bureaucracies took advantage of their regulatory authority to exact concessions and further expand their power. The Russian people, in turn, learned to look to the government for solutions to economic problems. The government's inclination to intervene in economic matters, coupled with popular support for such intervention, created a direct threat to the emerging securities markets.

Legal reforms also occurred during a time when adequate supporting institutions did not exist. The country lacked a transparent and efficient market for shares. So long as managements' actions did not affect share prices, no market dynamic existed for penalizing companies that failed to observe the rights and best interests of shareholders. Without this market mechanism, companies often engaged in technical compliance with legal requirements, but left the underlying concerns unaddressed.

In many respects, the status of and problems in Russian securities markets represented a normal phase of development. A company's need for capital and the need for business by brokers caused additional evolution in the market. Trading would, over time, become more transparent, with brokers providing information on price and companies disclosing adequate financial information and displaying less hostility towards outside shareholders.

The problem was that Russia lacked the time needed for gradual evolution. With bank loans unavailable and foreign investment at anemic levels, the capital markets increasingly represented the only source of financing for cash starved companies. Without more organized markets, this would remain difficult, if not impossible, and would threaten the country's economic recovery.

Facilitating the development of capital markets required less emphasis on legal reform and greater focus on improving the dynamics necessary for organized markets. Participants in the market had to appreciate the differentiation among brokers and companies before any standards would become meaningful. Before this could happen, Russia would be forced to face Vasiliev's day of reckoning.
2. PRIVATIZATION

Many of the problems in the development of the securities markets arose as a direct consequence of the privatization process. Privatization in Russia amounted to an extraordinary transfer of property rights from the public to the private sector. By the end of the first phase of privatization ("voucher privatization") in June 1994, seventy percent of government-owned enterprises had been transferred to private ownership, a remarkable achievement in only two years. The process was a rude shock to Russian industry. Few companies were prepared for the inevitable consequences of private ownership. In addition, governmental policies did not focus on post-privatization matters; the immediate goal was to get ownership out of the hands of the government as soon as possible.

Privatization occurred through a system of voucher auctions. Russian citizens received a privatization check or a voucher with a face value of 10,000 rubles or, at the time, about twenty-five dollars. The vouchers could then be used at auctions to bid for shares of privatized companies. The first voucher privatization took place in Nizhny Novgorod in 1992.

An auction involved the sale of only a minority of a company's outstanding shares. In recognition of the prevailing political realities, the privatization program contemplated the purchase of large, even controlling, blocks of shares by employees. Although ownership was now decentralized, both management and employees retained the ability to protect their own interests.

To become privatized, a company would select one of three plans of distribution. The first provided workers with the

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10 Voucher privatization continued, albeit in a reduced form, after June 30, 1994. The Mayor of Moscow announced that vouchers would continue to be accepted for privatized industries in the city. In addition, the government authorized the use of vouchers by employees when their company went private.

11 Each Russian national could obtain the voucher from a local office of Sberbank, the national savings bank. In total, approximately 150 million vouchers were distributed. High Stakes on the High Steppe, ECONOMIST, Oct. 16, 1993, at 89.

12 Privatization took place even earlier in Vladivostok. The sales, however, were for cash rather than for vouchers.

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option of acquiring twenty-five percent of the company's nonvoting shares while the management received five percent of the voting shares at a nominal cost.\textsuperscript{13} The second option permitted managers and workers to use either cash or vouchers to buy fifty-one percent of the company's voting shares, at a price equal to 1.7 times the July 1992 book value.\textsuperscript{14} Managers and employees could obtain an additional five percent through a vehicle resembling an employee stock ownership plan. Finally, as a third option, managers were allowed to buy forty percent of the company's outstanding voting shares. Management, however, had to offer assurances that the company would not cease operations.

Most companies chose the second option.\textsuperscript{15} This placed approximately sixty percent of the outstanding voting shares in the hands of management and employees.\textsuperscript{16} Typically, an additional twenty-nine percent of the shares were sold at voucher auctions. Additionally, local property funds received shares as compensation for the costs associated with auctions.\textsuperscript{17} The interests allowed property funds to maintain influence over privatized companies. Through mid-1994, therefore, property funds continued to own large blocks of privatized companies' shares.\textsuperscript{18}

\textsuperscript{13} Workers and managers could purchase an additional 10% of the shares at relatively little cost. These shares were placed in something resembling an employee stock ownership plan ("ESOP").

\textsuperscript{14} For an explanation of the calculation of book values of state operated corporations see, Maxim Boycko, et al., Privatizing Russia, 24-25 (August 1993) (paper prepared for the Brookings Panel on Economic Activity, Sept. 9-10, 1993) [hereinafter Boycko].

\textsuperscript{15} Some companies with high nominal share values, often those involving capital intensive industries, chose the first option. Few selected the third. See id. at 21 (noting that, by July 1, 1993, 77.8% of the companies had selected option 2; 21% selected option 1); see also International Finance Corporation & U.K. Know How Fund, Russia: The Legal and Regulatory Framework for Equity Investment, The Framework for Mass Privatization Annex 2, p. 2 (May 25, 1994) (draft discussion paper, on file with International Finance Corporation, Washington, D.C.) (noting that 75% of the companies selected the second option).

\textsuperscript{16} See Boycko, supra note 14 (table 1).

\textsuperscript{17} Property funds received preference shares that paid a fixed annual dividend of five percent of an enterprise's net profits. When sold, the shares automatically converted to ordinary shares.

\textsuperscript{18} The shares owned by the property funds allowed the government to have continued influence over company policies. One incentive to encourage the sale of these interests was the prohibition against public offerings for
The privatization process stimulated the development of the first free securities market in Russia. A liquid market for vouchers arose contemporaneously with the onset of privatization. With nearly thirty percent of a company's stock typically sold at voucher auctions, discernible groups had considerable interests in acquiring these shares. Management, for example, wanted to prevent the shares from falling into the hands of unruly outside investors. Conversely, outside investors wanted the shares to gain control and displace management. Both groups, therefore, had an interest in accumulating vouchers. At the same time, individual Russians had an incentive to sell vouchers and receive an immediate return, particularly given the early uncertainty surrounding the viability of privatization. As a result, a market in vouchers quickly developed.

The voucher system had a significant effect on the securities markets. First, it contributed to the development of classes of market intermediaries, such as brokers. For brokers, vouchers represented an early and critical source of business, something that would eventually evolve into the trading of equity securities of privatized companies. The voucher system also seemed destined to result in atomistic ownership patterns with large numbers of shareholders acquiring small amounts of shares. They would not, therefore, be able to influence management. The environment fostered the development of voucher funds. The funds accumulated vouchers from individual investors and used them to purchase large blocks of shares in privatized companies. The voucher funds represented Russia's first class of institutional investors.

The use of an auction to distribute vouchers also stimulated the development of a secondary market. The

companies in which the local property funds owned 10% or more of the shares. See infra note 105.

The market was also highly sensitive to material information about the privatization process. The price of vouchers collapsed in the early summer of 1994 as the voucher program ended. In early June, however, the Russian government announced a list of companies to be privatized, described by Anatoly Chubais as "the biggest jewels in the privatization crown." Julie Tolkacheva, As July 1 Nears, Voucher Prices Soar, MOSCOW TIMES, June 10, 1994, at 11. The market immediately reacted to the information, as voucher prices increased overnight by 10,000 rubles. See id.
auction process resulted in an artificial configuration of share ownership, with many individuals owning a small number of a company’s shares. In the post-privatization era, this configuration would need to be altered, a situation that would encourage secondary trading activity. With the rush to privatize, however, little thought was given to how the secondary markets would develop.

Privatization, therefore, resulted in the creation of a number of institutions and intermediaries necessary for the development of the securities markets. Moreover, by widely distributing shares, privatization resulted in a nation of investors, many of whom would want to be active in the securities markets.

At the same time, however, little was done to encourage companies to reorient themselves away from Soviet-style management. Resistant to change and the new economic realities, management had little interest in appealing to outside investors. In general, therefore, companies did not disclose meaningful financial information and opposed free floating shares which could fall into the hands of outside investors seeking to obtain control.

3. THE POST-PRIVATIZATION ENVIRONMENT

3.1. In General

The maelstrom of privatization meant that companies were suddenly forced to deal with the reality of outside investors. Managers and employees tended to own the largest percentage of shares. For these groups, profits were a secondary concern, outweighed by the goal of preserving jobs. Non-management employees wanted to avoid joining the burgeoning ranks of the unemployed, while managers wished to retain control over their corporate fiefdoms. The attitudes differed little from those that prevailed in the pre-privatization era.

Outside investors, however, had other interests. They were

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motivated not by the preservation of jobs, but rather by the desire to maximize returns. The rise of voucher funds intensified these divisions. The funds often promised high returns to individuals to induce them to contribute their vouchers. They therefore pressured management to pay dividends. Where management proved unaccommodating, the funds sometimes attempted to seize control and displace existing management.

The views of these two groups were antithetical. Both management and large outside investors focused on obtaining control, with the ultimate desire of ousting the other from the company. Since employees often owned the largest number of shares, management sought to control the their votes. It accomplished this by using devices such as “trust” arrangements and proxies, which gave management the right to vote the employee shares for an extended period (e.g., five-years).

The best method for ensuring control, however, was actual ownership of the shares. Management could buy the shares at auctions, which meant accumulating vouchers. Alternatively, management could purchase the shares for cash in the

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21 In other instances, the removal of the “old guard” was accompanied by economic upheaval. For example, both Germany and Japan witnessed purges of their corporate elite following World War II. Whatever the merits of penalizing these individuals for the conflict, the practice essentially made room for a younger, perhaps more adaptable, group of managers. This, however, has not occurred in Russia.

22 The use of coercion to control the votes of employees also found application in the voucher market. Some companies required employees to transfer their vouchers to management, perhaps at a nominal price. Even in the absence of such overt measures, management had other mechanisms for controlling the votes of employees. Russian law did not provide for confidential voting by shareholders. This allowed management to know how each of its employees had voted. Employees who voted against management risked losing their jobs, a real concern given the growing rate of unemployment.

23 The ability to accumulate and control shares held by employees in the short-term meant that management was relatively entrenched. As a result, little opportunity existed to displace the Soviet-style directors who remained from the days of central control. Leverage over employees, however, was at best a temporary solution. The shares distributed to employees were generally not placed in an aggregating vehicle such as an ESOP, but were owned individually. As a result, many employees sold their shares. Unless purchased by management, the sold shares ceased to be guaranteed votes for management.
"secondary" market. To do this, managers hired brokers to solicit the shares, a task greatly facilitated by management's control of the share registry. This represented a form of vertical integration, with the brokers often becoming directly identified with the company.24

Management went to great lengths to discourage and disenfranchise outside investors. The tactics ranged from the blunt—barring them from attending shareholder meetings, refusing to reflect transfers on the share registry—to the more subtle—organizing management-owned voucher funds and investor groups to ensure control over shares sold to the public.

Despite the seemingly chaotic nature of these activities, the battles took place within a surprisingly rich legal regime. Russia had both an extensive corporate code, and specialized regulatory provisions governing voucher funds, brokers, exchanges and stock offerings. The relatively full framework notwithstanding, early efforts to "fix" the problems between management and outside shareholders focused on enhancing the legal framework.

3.2. The Joint-Stock Company Law

The first step for every medium and large enterprise undergoing privatization was to reorganize as a joint-stock company.25 Established in 1990,26 the provisions governing the corporate form were adopted as regulations, with the Soviet government presumably anticipating a more permanent replacement. Regulation 601 contained a curious amalgamation of concepts, some seemingly borrowed from other industrial countries27 and others more attuned to the

24 Other methods of retaining control included the use of captive voucher funds. This approach had to address ownership limitations imposed on voucher funds, which could be circumvented by using more than one fund.
25 Companies with a book value of not less than fifty million rubles on January 1, 1992 had to reorganize as open joint-stock companies. Those with values between one and fifty million rubles could convert into joint-stock companies and participate in the voucher auctions if such action was requested by the employees and approved by the local property committee. See George G. Angelov, Legal Framework of Privatization in Russia, 2 MINN. J. GLOBAL TRADE 207, 207-08 (1993).
26 Regulation 601, supra note 6, Item 92.
27 For example, the regulations permit a dual board structure resembling

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particular needs of Russian enterprises. Essentially, however, the regulations provided for a conventional corporate form with ownership evidenced by registered shares. Additionally, a model charter adopted by presidential decree included further guidance in the corporate governance area.

A number of commentators have already sketched out the broad contours of Regulation 601, something that need not be repeated here. The regulation contained a number of provisions that made ordinary corporate governance more difficult and facilitated abuse by management. For example, the regulation required that a quorum of shareholders be present for a company to conduct business at a shareholders’ meeting, a conventional enough requirement. The requirement did not apply, however, to meetings rescheduled because of the lack of a quorum. Companies, the system of governance in Germany.

For example, this regulation required all joint-stock companies to create an audit commission, elected by and from shareholders. The commission had the authority to review financial statements and call extraordinary meetings. See Regulation 601, supra note 6, arts. 130-35.

The regulation did not provide for bearer shares. To the extent that companies attempted to circumvent the requirement, see infra notes 128-30, they did so by issuing bearer instruments that could be converted into shares. The law permitted the formation of “open” or “closed” joint-stock companies. The principal distinction was that shares of a closed joint-stock company could only be transferred with the consent of shareholders, unless otherwise specified in the charter. See Regulation 601, supra note 6, art. 7. Closed companies also had lower minimum capital requirements, although inflation made the distinctions between open (100,000 rubles) and closed (10,000 rubles) inconsequential.

Although the charter increased shareholder protection, it was flawed in that, even if adopted, it could be amended at a shareholder meeting. In some circumstances, companies amended their charter before the voucher auction, inserting provisions designed to minimize the role of outside investors. Amendments included provisions that required directors to be employees of the company or that classified the charter and information about insider holdings as “secrets.”

This statement is hesitantly made. No corporate code could have been drafted that would have eliminated all opportunities for abuse.
therefore, would schedule a shareholder meeting, cancel it due to the absence of a quorum, and then hold the rescheduled meeting immediately thereafter, sometimes within minutes of cancellation. In addition to allowing decisions to be made in the absence of a majority, this process also reduced the incentive to fully canvass and notify shareholders of an upcoming meeting.33

Moreover, Regulation 601 allowed shareholders to vote either in person or by power of attorney. The power of attorney, however, had to be notarized, an expensive process in Russia. Companies would therefore agree to pay the costs of notarization in return for an employee's pledge to vote in a manner acceptable to management. Employees who took part in this process would often designate management's agent to vote the shares. In some instances, the power of attorney had a duration as long as five years.34

A number of provisions also made any change in management more difficult, further insulating former state-supported directors from the possibility of removal. Directors could not be removed before the expiration of their terms.35 The use of two year terms exacerbated the problem.36 Similarly, the general director had considerable autonomy.37

33 The failure to notify all shareholders had a disproportionate impact on outside investors. Employees, the shareholders most likely to support management, could be and typically were notified in advance by notices posted in the workplace. Reaching outside investors required the use of certified mail, a requirement that made the process more expensive. Because of the cost and uncertainty of their support, management was least likely to encourage these outside investors to attend the meeting.

34 The regulation also contained additional cumbersome provisions which, given circumstances in Russia, protected shareholder interests. Shareholders had to approve an increase in share capital before any offering could occur, although only by a "simple majority vote." Regulation 601, supra note 6, art. 39. Because company law largely did not permit the use of authorized but unissued shares, shareholders had to approve any new issue of shares. While this could delay the public offering process, it also limited management's ability to issue additional shares and dilute the interests of existing shareholders.

35 Id. art. 113. In addition, some companies inserted provisions into their charters extending the terms of directors to as long as five years.

36 Id. art. 39. Of course, not all of the provisions were stacked in favor of management. See id. (Stating that management could not issue additional shares without first obtaining shareholder approval.).

37 Regulation 601 provided that the general director "shall have the right without a power of attorney to effectuate actions in the name of the society."
The equivalent of a company’s CEO, the general director was elected directly by shareholders. Once elected, therefore, neither the shareholders nor the board had effective means of controlling the general director for the remainder of the term.

In the immediate post-privatization era, management took advantage of these “gaps” in the regulatory framework to maintain control over companies. This, however, was less a reflection of flawed draftsmanship or inadequate legal regimes and more a recognition of management’s willingness to use any device - legitimate or illegitimate - to preserve its position. With no market penalty for this approach and with dire consequences for complacency, management’s attitude was inevitable.

3.3. Shareholder Governance

The problems between management and outside investors defied legal solutions. A series of laws and presidential decrees attempted to eliminate the most pronounced abuses, with little success.

The first significant attempts at regulatory reform focused on reducing management's ability to manipulate share registries, an area largely unregulated by Regulation 601. Regulation 601 provided only that companies had to maintain a register of shareholders. Most companies controlled their own registers, although sometimes contracting out the responsibility to a broker.
Companies used registers to control shareholder behavior. Russia had nothing resembling a system of ownership disclosure. Large shareholders had no obligation to disclose their interests after crossing significant ownership thresholds.\footnote{42} This meant that large, sometimes controlling, blocks of stock could be acquired secretly. Companies responded to these activities by refusing to recognize the transfers on the share registry.\footnote{43}

The problem of share registries drew a concerted response from the Russian government. A presidential decree issued in October of 1993 required that large companies use an independent registrar.\footnote{44} In April 1994, the GKI and the Russian Federation Commission on Securities and Exchanges ("RFCSE") jointly issued regulations governing company registers.\footnote{45} The provisions specified the requirements for a shareholder register, the procedures for maintaining it, the

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\footnote{42} In the United States, for example, shareholders acquiring more than five percent of a class of equity securities of a public company must disclose that interest and their intent in a Schedule 13D. \textit{17 C.F.R. § 240.13d-2} (1991). Purchasers of 15\% of the shares of joint-stock companies in Russia must file with the Ministry of Finance. See \textit{The Regulations for the Issue and Circulation of Securities and for Stock Exchanges in the RSFSR, Vedomosti RSFSR, Issue 78, Item No. 7-8, § 5, art. 49} (1991) [hereinafter SP RSFSR No. 78]. Those acquiring more than 35\% of a company or where the shares represented more than 50\% of the total voting shares, are required to seek permission prior to purchase of the RSFSR State Committee for Price and Support for New Economic Structures. \textit{See Regulation 601, supra} note 6, art. 147; \textit{see also} SP RSFSR No. 78, supra, art. 50. In addition, foreign investors investing more than 100 million rubles generally had to receive approval from the Russian Agency for International Cooperation and Development. These filings, however, were with the government and were not public.

\footnote{43} See \textit{Press Luncheon, supra} note 20 ("We know that today more often than not the register is a secret boom which the director keeps in his safe and will not show anyone even under the threat of death."). The attempts to use the share registry were not limited to controlling blocks. Some companies had in their charters limits on total ownership and refused to register trades that exceeded that amount. This proved to be a particularly thorny problem for shares in nominee accounts.

\footnote{44} The decree did not define "independent." As a practical matter, companies often fulfilled the requirement by transferring responsibilities for maintaining the register to a broker.

\footnote{45} \textit{REGULATION ON A JOINT-STOCK CO. SHAREHOLDER REGISTER Protocol No. 2 art. 18.04} (Commission on Securities and Exchanges of the President of the Russian Federation, 1994) (on file with the \textit{Journal}).
Registries were not the only focus of reform efforts. The 1994 Privatization Decree also contained a number of provisions that addressed the issue of shareholders' rights. These included provisions requiring equal treatment of shareholders, annual meetings of shareholders within 120 days of the end of the calendar year, a distribution of materials relevant to shareholders, the approval of seventy-five percent of the outstanding shares at the meeting for certain actions, limitations on the issuance of shares, cumulative voting, a board with independent directors, and a prohibition against companies voting their unissued shares. The provisions also granted to the RFCSE the

48 The regulations also addressed the issues of nominee ownership. They recognized the status of a "share possessor," a person "who holds shares in his own name on behalf of another person . . . without being the owner of the shares." *Id.* art. 6.1. The rules imposed some basic obligations but otherwise specified that the share possessor would have whatever rights were provided by contract with the owner of the shares. *Id.* art. 6.2.

49 *Id.* art. 9.10.1 (stating "all common shares of an open joint-stock company shall entitle their holders to equal rights and shall pay equal dividends, regardless of their date of issue").

50 *Id.* In addition, the provision required the board to approve financial statements within 60 days after the end of the fiscal year. Failure to do so would result in the delivery of the balance sheet to the tax inspector's office, which would then perform an audit at the company's expense. The provision was presumably designed to ensure that the company had prepared financial statements sufficiently in advance of the meeting of shareholders. *See id.*

51 No later than 30 days before the meeting, shareholders were to be sent written notice of the meeting, an agenda approved by the board, and information on agenda issues, including a ballot. *Id.* art. 9.10.7.

52 *Id.* art. 9.10.2. The requirement applied to: amendments to the charter, changes in charter capital, the disposition of substantial portions of the company's assets (defined as an amount exceeding 25% of the charter capital), participation in holding companies, association of enterprises and financial industrial groups, and reorganizations or liquidations of the company. *Id.*

53 *Id.* art. 9.10.3.

54 *Id.* art. 9.10.4.

55 The provision does not specifically require independent directors. Rather, no more than one-third of the directors may be employees of the company. *Id.*

56 *Id.* art. 9.10.5. This apparently was designed to prevent the company
authority to develop regulations concerning the "procedure for preparing and conducting the general meeting of open stock companies."\textsuperscript{56}

None of these reforms had a discernible impact.\textsuperscript{57} Some companies began to utilize "independent" registrars, as required by the presidential decree. With no definition of "independent" in the decree, and no market mechanism to ensure compliance with its spirit, companies often conformed to the technical, but not to the intent, of the requirement.\textsuperscript{58} The register would typically be given to a broker that worked closely with the company. Other companies established their own "pocket" registrars, entities that were created to appear independent, but which in reality were under the control of the company. If anything, the reform attempts worsened matters.\textsuperscript{59}

3.4. Assessment

Although flaws in the legal system may have accentuated some abuses, these laws represented only a small part of the overall problem.\textsuperscript{60} The problems arose primarily from market dynamics that resulted from the method of privatization. No

\textsuperscript{56} Id. art. 9.10.7.

\textsuperscript{57} Six months after Yeltsin's decree on registries, Anatoly Chubais described it as the "main problem" in connection with "the creation of the securities market." \textit{Press Luncheon, supra} note 20.

\textsuperscript{58} See \textsc{Regulation on a Joint-Stock Co. Shareholder Register supra} note 45, art. 5.2 (requiring that the "holders of a share register . . . be . . . legal persons which are not shareholders of the Joint Stock Company concerned with or exercising control over its shares").

\textsuperscript{59} Brokers could monitor trades, providing added sources of business. They could also refuse to register trades. In at least one instance, a company holding shares in nominee name was refused the right to register. Stories circulating in Moscow indicated that in other instances, brokers or other registrars would charge high fees, sometimes a percentage of the value of the transaction, before registering the transaction.

\textsuperscript{60} Some still ascribe the disorganized securities markets to a lack of sufficient legal infrastructure. See, e.g. Elif Kaban, No Regulation, No Security in Russian Securities, \textsc{The Moscow Times}, July 6, 1994, at 12 ("The government, too busy trying to keep Russia together, has delayed the introduction for nearly two years of a crucial securities law which would ensure transparency and liquidity.").
amount of legal change could have prevented these abuses and problems. They would cease only when companies and outside investors learned that their disparate views were reconcilable.

The early attempts at shareholder protection through changes in the legal regime, particularly those concentrating on registers and shareholder rights, had little impact. Nor did they seem to accelerate the replacement of former Soviet-style directors. Nonetheless, it would be wrong to say that these efforts were wasted. In line with Vasiliev's assessment, as the markets continued to evolve, reforms would become more relevant.

To the extent that market dynamics would affect the behavior of management, the development of large institutional investors seemed destined to play a pronounced role. Voucher funds acted as aggregating entities, accepting small numbers of vouchers from large numbers of investors and using them to buy large blocks of shares in privatized companies. They therefore seemed to be in a position to act as a check on management. Market dynamics, however, dictated a different outcome.

61 For example, the Ministry of Finance required companies engaging in a public offering to include audited financial statements in the prospectus. See infra text accompanying notes 112-116. Companies, though, would sell shares in a newly formed shell company, thereby avoiding any meaningful financial disclosure. See infra text accompanying notes 124-25.

62 Despite the unique transformation taking place in Russia, this pattern of behavior has an almost universal quality. Managers want to preserve their jobs. Investors want to maximize returns on investment. To many, these seem to be antithetical goals. Both, therefore, saw their particular goal as paramount and both exploited gaps in the law or weaknesses in the legal system to strengthen their position and vanquish their opponent. This type of dynamic exploitation of legal regimes has occurred in the United States in connection with the regulations governing takeovers. See J. Robert Brown, Jr., Regulatory Intervention in the Market for Corporate Control, 23 U.C. DAVIS L. REV. 1 (1990).

63 See Press Luncheon, supra note 20 ("This is the most important problem today. If you talk to any serious foreign investor considering the problem of whether or not to invest in a specific enterprise, the first and most important thing is the personality of the head.").
4. THE ROLE OF MARKET INTERMEDIARIES

With the distribution of vouchers and the sale of company shares, the market had a significant need for intermediaries. In the aftermath of privatization, two developed immediately: brokers and voucher funds. Both played important roles in the early development of the market. Their functions, however, were not in line with conventional western notions, but rather were shaped by the unique conditions of the Russian markets.

Since a traditional secondary market did not exist, the primary function of brokers was not to bring together buyers and sellers for the purpose of reselling shares, but rather to act as an agent for those trying to accumulate blocks, often controlling blocks, of shares in companies. Voucher funds represented the first significant institutional investor in Russia. Subject to the jurisdiction of the State Committee of the Russian Federation for the Management of State Property (Goskomimushchestvo or, more commonly, GKI) and, eventually, the RFCSE, the funds issued shares primarily to individuals in return for vouchers. They often attracted investors through promises of exorbitant returns, thus placing pressure on funds to show quick and bountiful profits. In many instances, this meant obtaining control of the companies and displacing the existing management.

As with other areas in the corporate realm, the voucher funds were subjected to a basic regulatory framework. The provisions distinguished between ordinary investment funds

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65 According to estimates, the voucher funds in the aggregate had, by April 31, 1994, accumulated in excess of 45 million vouchers. The funds also had a total of approximately 20.69 million shareholders. The size of the funds created immediate logistical problems. As aggregating entities, funds had large numbers of shareholders that had contributed a small number of vouchers. As with joint-stock companies, funds were required to hold annual meetings of shareholders. See Russia: Battle for the Boardrooms, Euromoney, July 19, 1994 (noting that 44% of all vouchers issued in privatization were held by voucher funds).

66 SP RSFSR. 1186, supra note 64, Supp. No. 1 § 4.
and voucher funds. The distinction was more than mere semantics. Voucher funds remained subject to the jurisdiction of GKI, while ordinary investment funds remained subject to the Ministry of Finance.

The regulatory system required the licensing of all voucher funds. The largest fund registered directly with the GKI, while the smaller funds did so with local property management committees. The ability to revoke a license provided GKI with some leverage, although as a practical matter it rarely proved a credible threat.

In many respects, the structure of the funds was not unique. The law contemplated the use of a manager, with the

67 Id. Article Nine of the decree provided that GKI would adopt regulations concerning the suspension of funds, the regulation of share offerings, the licensing of managers and the regulation of the procedures governing the exchange of shares between property funds and voucher funds. These regulations were issued a month later. See Typical Regulations on Licensing of the Activity of Special Investment Funds for Privatization Intended to Accumulate Citizens' Vouchers, of Managers of these Funds, and on the Suspension and Revocation of Licenses: Approved by Order of the State Committee of the Russian Federation for the Management of State Property, No. 695-R Nov. 4 1992, reprinted in 2 THE PRIVATIZATION MANUAL, Doc. H-4 at 1 [hereinafter TYPICAL REGULATIONS].

68 Indeed, the law preserved the division among bureaucracies by eliminating overlap in a number of specific situations. Banks and insurance companies as well as other institutions were regulated by the Ministry of Finance and the Central Bank, and those operated as voucher funds were excluded from the Voucher Fund Law. See SP RSFSR No. 1186, supra note 64, § 3 (Supp. 1 1992). This meant that there would be no overlapping jurisdiction between these bureaucracies and the GKI. See id.

69 See id. § 21 (establishing a licensing requirement). To obtain the license, the funds had to provide copies of their charter, an application (which identified all officers, directors, the manager, depository, affiliates, and the independent auditor), a prospectus describing the issue, a copy of the management and depository agreements and a copy of the manager's license. Id. § 22.

70 Newly established funds with capital of 50 million or more rubles, open joint-stock companies licensed as funds with capital of 1 billion or more rubles, and funds set up with the participation of foreign capital had to register with GKI. Fund managers also had to register with GKI. TYPICAL REGULATIONS, supra note 67, Doc. H-5, 1-2. Smaller funds were to register with the "territorial committees for the management of state property." Id.

71 Among other things, the regulations permitted license revocation or suspension for false or misleading statements made during the application process, for the refusal to provide the licensing body with requested information and for engaging in transactions prohibited by law. Id. Upon suspension, the fund had 30 days to correct the deficiencies and receive reinstatement. Id.
manager's contractual agreement subject to shareholder approval. It also recognized the need for certain basic protections, including the requirement that a majority of the fund's board consist of independent directors and the imposition of restrictions on related party transactions.

The provisions also imposed a number of substantive restrictions. Funds could not accumulate more than ten percent of the voting shares of any company (later elevated to twenty-five percent), or place more than five percent of their net assets into the securities of a single issuer. The provisions also provided that the funds could not invest in securities issued by their manager, depository or independent auditor, or any shareholder owning five percent or more of the fund's shares. Nor could funds engage in pyramid schemes; investments in other funds were expressly prohibited.

Finally, the law contained specific disclosure obligations. It required quarterly and annual reports, including a balance sheet and a statement of the fund's net asset value. The materials had to be certified by the independent auditor and made "available" to shareholders within thirty days after the end of each quarter and sixty days after the end of the fiscal year.

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72 See SP RSFSR No. 1186, supra note 64, Supp. No. 1 § 24. The United States has a similar system in place under the Investment Company Act of 1940.

73 Here, independent meant not being the manager, the independent auditor, or its affiliates. Id. Supp. No. 1 § 18.

74 Id. Supp. No. 1 § 30. Specifically, the provision required board approval of certain contracts between insiders (manager, officers and directors of the fund) and companies in which the fund had invested, and between the fund and another entity in which an insider had a financial interest.

75 The percentage was increased in the 1993 privatization decree. See 1993 Privatization Decree, supra note 47; see also Elisabeth Rubinfien & Janet Guyon, Savvy Young Men Russia's Alfa Fund Makes Waves, Profit in Voucher Investment, WALL ST. J. EUR. July 12, 1994, at 1, 12.

76 See SP RSFSR No. 1186, supra note 64, § 20 (Supp 1, 1992).

77 Id.

78 Id.

79 Id. § 37.

80 Id.

81 Id. The funds also had to make available within 60 days after the end of the fiscal year, free of charge, information on all contracts and transactions entered into by the fund and all payments made between the
As privatization continued, the number of funds greatly increased.\textsuperscript{82} By May 1994, 659 funds existed, of with 121 registered with GKI and 538 listed with the local property committees.\textsuperscript{83} Despite the large numbers, however, most were small and unlikely to survive in a post-privatization, post-voucher era.\textsuperscript{84}

In some respects, the voucher funds represented a counter-weight to management. The funds could accumulate large blocks of shares in privatized companies.\textsuperscript{85} With Russian companies dominated by soviet style directors, who often controlled substantial blocks of stock, voucher funds emerged as potential guardians of the interests of outside investors.\textsuperscript{86}

The funds, therefore, were often vocal critics of management's practices, including its treatment of shareholders. Yet from the very beginning, they themselves

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manager (and affiliates) and any entity in which the voucher fund was, at the time, an investor. \textit{Id.} § 38.

\textsuperscript{82} The largest voucher funds as of April 1994 in terms of vouchers were: First Voucher Fund; Alfa-Kapital; Neftalmazinvest; MMM Invest; and Moskovskaya Nedvizhimost. First Voucher, for example, has 4.5 million shareholders. \textit{See} Euan Craik, \textit{Voucher Funds Lost in Sell-Off Shuffle}, \textit{The Moscow Times}, Oct. 26, 1994.

\textsuperscript{83} These numbers do not, of course, include unregistered funds. Moscow had the largest number of registered funds, 140, with another 24 in the Moscow Oblast. St. Petersburg, the location with the second largest number of funds, had only 41, none of which were registered with GKI. The number of licensed funds showed a steady increase, growing to 650 as of May 31, 1994. \textit{See Voucher Investors Face Lean Times}, \textit{Moscow Times}, May 31, 1994 at 15.

\textsuperscript{84} According to a study of 90 voucher funds by the State Property Committee, 12 had assets of under one million rubles (approximately $525). \textit{See} Julie Tolkacheva, \textit{Voucher Investors Face Lean Times}, \textit{Moscow Times}, May 31, 1994, at 15. Only one-third of the funds studied paid dividends to shareholders. \textit{Id.}

\textsuperscript{85} The motivation was, of course, economic. The only way they could be assured an adequate voice in management decisions and an adequate return on their investment was to obtain control of the company. Voucher funds did not pursue an investment strategy of diversification. Instead, they often preferred to concentrate investments in a small number of companies in order to exert their influence over management. \textit{See} Geoff Winestock, \textit{Threat Seen Lurking for Funds}, \textit{Moscow Times}, May 31, 1994, at 15.

\textsuperscript{86} Of course, the fund's ultimate goal was not antagonism with management, but profit-making. To the extent working with management generated attractive results, the funds were often just as likely to collaborate. \textit{See id.} at 15 (noting that First Voucher Fund would use assets to buy shares in privatizing companies and then would immediately resell the shares at a higher price to management seeking to consolidate control).
engaged in a variety of questionable practices. In particular, they had a poor record of communicating with shareholders, a situation exacerbated by logistics. Funds also commonly relied on advertisements promising what amounted to unsustainable returns. Additionally, the funds sometimes exceeded investment limitations and failed to protect shareholders' rights.

Those funds not engaging in such dubious practices raised other concerns. Many funds seemed to be self-liquidating. Studies indicated that funds' average annual expenses equaled approximately 116 million rubles (approximately $60,000). With some funds unable to obtain a clear source of income, particularly given the unwillingness of many companies to pay dividends, they often obtained operating funds by selling shares.

Overall, funds as a check on management represented at best a mixed blessing. Funds could play a role in displacing former state supported directors, but were not necessarily driven by the best interests of the company. The majority of funds were primarily concerned with a quick return on their

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87 A number of fund-related scandals emerged. In March 1994, the president of Oil-Diamond-Invest was arrested and at least one-half million vouchers reported missing. Craig Mellow, Can Russia Vouch for Its Honesty?, INT'L. HERALD TRIB., June 4-5, 1994, at 11; see also Alexei Grammatchikov, Point of No Return: Russia's Fund Scams, MOSCOW TIMES, May 28, 1994, at 1.

88 Some of the reasons for the inattentiveness were practical. With so many individuals contributing one or two vouchers, the funds found themselves with enormous numbers of small shareholders. They often lacked the resources to send a notice of the meeting by registered mail to every shareholder.

89 See infra note 101.

90 The problems ranged from refusing to hold annual meetings of shareholders to holding meetings without a quorum.

91 "The small [voucher funds] are mostly run by cowboys. However, the larger ones—like First Voucher and Alfa, which between them have collected 4.8 m[illion] vouchers—are turning into serious investment managers with amazing speed." High Stakes on the High Steppe, supra note 11.

92 In general, the abuses went unchecked by regulatory officials, though some enforcement activity did occur. In the oblasts, property management committees, often in consultation with local prosecutors and finance and tax offices, did conduct inspections of funds or attempt to prosecute some of the most serious frauds. Enforcement activity at the federal level, however, remained essentially nonexistent.
investments and did not attempt to improve management skills or long-term profitability.

In more developed markets, the goals of profitability and improved management usually coincide. This was not, however, the case in Russia. Due to a high inflation rate and the absence of a liquid secondary market, long-term investments and improvements in performance were not favored. Instead, the funds focused on large investments followed by quick liquidation, often selling to a strategic investor.\footnote{Some funds have publicly indicated that these types of transactions represent the best hope for profitability and have specifically disparaged diversified, small investments as an acceptable alternative. See Winestock, \textit{supra} note 85, at 15.} Among other things, this meant that any financial investment returns accrued to the fund rather than the company.

The case of Vermani, a pasta manufacturer in Nizhny Novgorod, illustrated the realities of investment fund ownership. Favored by the government, the company possessed foreign-made machinery and had access to high-quality raw materials from external suppliers. Recently modernized, the company re-tooled during a four year period beginning in 1989. Vermani was, therefore, well positioned to carve out a niche in the privatized Russian economy.

In privatizing, the company selected the second option.\footnote{\textit{See supra} § 2.} Management and employees acquired fifty-one percent of the shares, while twenty-nine percent were sold at a voucher auction. One of the largest voucher funds in Russia purchased sixteen percent of the shares. The fund was consigned a minority position, with managers and employees owning a majority of the shares. The former state supported directors, therefore, were firmly in control.

Vermani, however, did not escape the Russian economy. Purchasers of the pasta, experiencing financial difficulties, fell behind in their payments. As a result, Vermani could not pay its suppliers, threatening continued production. To remedy the situation, a general manager of the company attempted to institute a number of reforms, most noticeably requiring purchasers to pay cash on delivery. The manager also wanted to implement a marketing and advertising campaign, as well
as a search for foreign investors.

The general director, a hold-over from the central planning days, objected to the new approach. At the December 1993 shareholders' meeting, the general director and other old style directors were ousted. The reform oriented manager succeeded in becoming the general director, but only after striking a faustian bargain with the voucher fund. The reconstituted board included the manager, a representative of the property fund, a representative of employees, and two representatives of the fund. One of the fund's directors was elected Chairman with the property fund's support.

The directors clashed almost immediately. The Chairman insisted that suppliers provide one month of raw materials in advance of any payment. This policy was rejected by a number of suppliers, which caused the plant's production level to fall. As conditions worsened, the voucher fund continued to accumulate shares, finding willing sellers among investors unhappy with the company's declining prospects and among the previously ousted managers. By March 1994, the fund's holdings climbed to thirty-one percent, while the percentage held by employees and management fell to forty percent. The local property fund continued to own twenty percent.95

The fund, therefore, played a significant role in the removal of the old-line management, a necessary condition for the company's success. Nonetheless, with two directors on the board, and the post of Chairman, the fund obtained control of the company. The fund did not, however, intend to use control to further the long term prospects of the company, but to achieve the short term benefit of bringing in a strategic investor. In short, that meant replacing the company's management, whether or not competent, and selling to an investor,96 with the company not benefiting directly from the

95 Voucher funds could not purchase more than 15% of a company's shares. Funds, however, sometimes used a management group to buy additional shares and skirt the restriction. See Rubinfien & Guyon, supra, note 75, at 12.

96 In a more efficient market, a strategic investor might retain existing management if deemed competent. In Russia, however, the lack of market checks on managerial behavior placed a heightened premium on selecting those that would run the company. As a practical matter, therefore, strategic investors wanted their own designees, irrespective of the existing management's basic competency.
transaction.\textsuperscript{97}

Funds, therefore, represented a mechanism for displacing existing management. This was only possible in companies where management had not consolidated its control through the acquisition of company shares, or in the case of Vermani, where existing divisions within the company meant that employees would not act in a unified fashion. On the other hand, from the perspective of possible insurgents within a company, relying on voucher funds and other outside investors to displace existing management represented a doubled-edged sword.

5. THE BEGINNINGS OF MARKET DISCIPLINE AND THE EMERGENCE OF THE PRIMARY OFFERING PROCESS

As a device designed to influence management, voucher funds were only occasionally effective. The capital markets represented another possible mechanism for influencing the behavior of management. Initially, however, this was not the case. By selling shares for vouchers rather than cash, managers had little awareness of the relationship between profit enhancing behavior and the attraction of capital. Moreover, aware of examples such as Vermani, management developed an aversion to free-floating shares.\textsuperscript{98}

Nonetheless, by late 1993, companies desperate for capital began to sell shares for cash in primary distributions. This raised the possibility that the desire to attract outside investors would cause a shift in management’s behavior. Again, however, the realities of the Russian markets dictated a different result. Russian capital markets were highly disorganized and not yet capable of absorbing large offerings. The market was also atomistic. Formal links among the brokers were weak. Although brokers sometimes created

\textsuperscript{97} This assumes that a strategic investor otherwise would have had to purchase the shares directly from the company. In that way, the investment would have benefited the company directly. Often, however, this would not be the case. With management having accumulated large numbers of shares, the strategic investor could purchase a controlling block directly from them. Whether from management or from a voucher fund, the acquisition would not benefit the company directly.

\textsuperscript{98} Examples such as Vermani reinforced the views of soviet style directors that free-floating shares constituted a danger that should be avoided.
informal contacts within their own regions, the networks tended to be ad hoc and did not operate interregionally. With little secondary trading taking place, brokers had few reasons to relate with those in other regions.\(^{99}\)

With the links among brokers poorly developed, particularly on an interregional basis, selling-syndicates were difficult, if not impossible, to create.\(^{100}\) Companies interested in offerings, therefore, had to arrange their own selling efforts. This initially meant aggressive advertising, with television commercials and subway advertisements promising 2000% returns.\(^{101}\)

In addition, the infrastructure necessary to facilitate secondary trading did not exist.\(^{102}\) Russia had no central

\(^{99}\) Automobile All-Russian Alliance ("AVVA") probably was an exception. It constituted the first real national offering. See infra note 124.

\(^{100}\) Syndicates within a particular region were possible, since groups of brokers knew each other and often worked together. Given the size of the regional market, intra-regional syndicates in places such as Moscow had significant placement power.

\(^{101}\) These types of advertisements obviously appealed to base motivations such as greed. In should be noted, however, that Russia still had an inflation rate above 100% by mid-1994. Individuals were therefore attracted by a return that would maintain the real value of money, requiring rates far beyond those in the United States. The flagrant use of advertisements led to a presidential decree on the subject, although with little impact immediately apparent. See Decree of the President of the Russian Federation on Protecting Consumers Against Misleading Advertising, Vedomosti SRSR, Issue No. 1183 (1994). The decree attempted to prevent promises of excessive returns by requiring the disclosure of the "actual amount" of interest or dividends paid in a prior period, and prohibiting the provision of information about future payments. The decree applied to advertising in the mass media, as well as other public advertisements, such as billboards and vehicles. At least from a cursory review of advertisements on Russian television, the commercials for investments continued to display piles of money and use other methods of hype, but deleted all references to specific returns. Another decree prohibited advertisements from containing guarantees of future dividends. Decree of the Russian Federation on Protecting Interest of Investors Vedomosti RSFSR, No. 1233, No. 4 (1994). The same decree also indicated that the use of knowingly false advertisements would be the basis for voiding an offering of shares. Id. § 9.

\(^{102}\) Generalizations such as this must be made carefully and are subject to a host of exceptions. An active market did exist for shares of companies that were the subject of attempts to acquire or retain control. Typically, purchasers would commission brokers to scour the market for shares. In a few instances, issuers would promise to repurchase their own shares, although the substance of the promise was often unclear. Finally, a secondary market of sorts existed for some foreign investors. While most foreign investors came in as strategic partners, a few were buying small
location for reporting transactions. Nor had an appreciable quantity of trades occurred over licensed stock exchanges. The vast number of transactions were executed in the over-the-counter market ("OTC"). The OTC had little transparency, with brokers neither reporting the quantity nor the price of the transaction.

Similarly, no defined rules of behavior existed within the brokerage community. They had not engaged in significant self-regulation. Moreover, while some exchanges had established rules regulating brokers, the restrictions had little salutary effect. As a result, brokers did not report trades, observe limits on mark-ups charged on shares, or recognize fiduciary-type duties to clients.

The markets, therefore, had significant problems with transparency and differentiation. In the absence of listing standards, transparent share price information, and rules of behavior for brokers (whether imposed by the government or through some type of self-regulation), the market had no way of distinguishing legitimate companies from illegitimate ones. Small investors could not distinguish sound investments from unsound ones, or even if they were paying a "fair" price for the shares.

5.1. Primary Offerings

Privatization meant that although the lingering interest of the local property funds provided some opportunity for continued state interference, the government in most instances

percentages of Russian companies by 1994. Stories of the tremendous undervaluation of business assets in Russia had spurred some to take a harder look at the country. Only a handful of foreign brokers had a significant staff in Russia, with Credit Suisse First Boston having the largest presence.

In early 1994, a trading association began in St. Petersburg. The association did not, however, adopt rules governing broker behavior. See discussion infra § 7.2.

Practical impediments also existed. In many instances, management had gone to great lengths to acquire a controlling block of shares. An offering could dilute the controlling block. As the prior example of Vermani in Nizhny Novgorod illustrates, see supra notes 94-97 and accompanying text, having too many freely transferable shares meant that outside investors, including voucher funds, could acquire large, perhaps controlling, blocks and use them to displace management.
no longer controlled enterprises.\(^{105}\) Production was to be determined by market forces rather than government fiat. The demise of central control also meant an end, for the most part, to government financing.\(^{106}\) Funding had to come from the capital markets.\(^{107}\)

In recognition of this fact, the Russian government established an extensive system to regulate primary offerings.\(^{108}\) Shares had to be registered with the Ministry of Finance and had to be accompanied by a prospectus.\(^{109}\) A public issue included offerings of shares to more than 100 persons, or having a value of more than fifty million rubles (an increasingly insignificant threshold with the continuing

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\(^{105}\) To encourage property funds to dispose of their residual interest, the privatization program prohibited companies with more than 10% of shares owned by a property fund from issuing additional shares. MODEL CHARTER, supra note 6, art. 5.3.6. Given the immense need for capital in the post-privatization world, this was potentially a significant incentive. Of course, as long as the capital markets remained undeveloped, foreclosing that avenue, the threat was minimal.

\(^{106}\) Voucher funds, in contrast, were regulated by the GKI. Funds had to register shares with that organization or a local property management committee. See SP RSFSR, No. 1186, supra note 64.

\(^{107}\) Banks, of course, represented another potential source of funding. Bank financing as a source of long-term capital is not without historical basis. Japanese banks through the 1970's provided most of the funding needs of companies. The Japanese government (particularly the bureaucracy) played an active role in deciding who was to receive funds from banks. At least with respect to foreign banks, this provided an implicit guarantee of repayment. In Russia, however, this system would be difficult to implement. In general, Russian banks do not make long-term loans to industry, particularly given the difficult financial condition of most Russian companies. Nor is it likely that the Russian bureaucracy has the skill or experience to administer a loan program like the one used in Japan.

\(^{108}\) With the concept of authorized but unissued shares absent in Russia, the first step of the offering process was shareholder approval. Under Regulation 601, an increase in share capital required the approval of a majority of outstanding ordinary shares. See Regulation 601, supra note 6, art. 39. For companies subject to the 1994 privatization program, the percentage necessary to approve an increase in charter capital was 75%. MODEL CHARTER, supra note 6, art. 9.10.2. See also Ministry of Finance Instructions No. 2, art. 4(a) (1992) (as amended on Jan., 27 1993, Feb. 4, 1993 & Nov. 15, 1993).

\(^{109}\) Ministry of Finance Instructions No. 2, supra note 108, art. 7. Depending on the size of the offering, the filing will be made either with the Ministry of Finance or a regional subdivision. According to the provision, approval must be within 45 days. Id.
decline in the value of the ruble).\textsuperscript{110} Companies also had to pay a tax on the funds raised from the issue of shares.

The Ministry of Finance adopted relatively rigorous content requirements for prospectuses.\textsuperscript{111} They included three years of "audited" accounting balances,\textsuperscript{112} financial information for the most recent quarter,\textsuperscript{113} disclosure of all shareholders owing at least five percent of the outstanding shares,\textsuperscript{114} a "[b]rief description of the issuer’s property and basic types of its activity,"\textsuperscript{115} and a discussion of any legal sanctions imposed on the issuer.\textsuperscript{116}

In addition, the prospectus had to include information on the offering, including both a description of the securities and the payment terms,\textsuperscript{117} and a description of the use of proceeds.\textsuperscript{118} The document had to include risk factors\textsuperscript{119} as well as some prospective information.\textsuperscript{120} Finally, the

\textsuperscript{110} SP RSFSR No. 78, \textit{supra} note 42, art. 42(b). The regulation also permitted private placements. \textit{Id} art. 4(2). A private placement could only be done “without public announcement” or a “publicity campaign.” \textit{Id}. In July 1994, the ruble fell to 2000 to the dollar, making 50 million rubles worth only $25,000.


\textsuperscript{112} \textit{Id}. § 10.

\textsuperscript{113} \textit{Id}. § 11.

\textsuperscript{114} \textit{Id}. § 3.

\textsuperscript{115} \textit{Id}. § 12. The prospectus also had to elucidate “in detail” the “[p]rospects for the sale of products to be manufactured” as well as the “availability of raw materials, accessory items, production floor-space, and work force therefore.” \textit{Id}. § 29.

\textsuperscript{116} \textit{Id}. § 19.

\textsuperscript{117} \textit{Id}. § 22-26.

\textsuperscript{118} \textit{Id}. § 28. The provision provided that the prospectus had to disclose “[t]rends in using financial resources mobilized by the issue of securities (setting up of new production facilities, or expansion, modernization or reconstruction of already available facilities, nature conservation measures, development and introduction of new productions processes, etc.) involving appropriate feasibility studies.” \textit{Id}.

\textsuperscript{119} See id. § 29 (“Risk factors shall be analyzed separately from economic, social, technical and ecological factors.”).

\textsuperscript{120} See id. (“If financial resources are to be invested in construction or reconstruction of facilities, information shall be submitted on the availability of a construction site, documentation on estimated expenditures, contractor capable of completing given construction and erection work within a planned time limit.”); \textit{see also id}. §28 (requiring disclosure of “[t]rends in financial resources”).
regulations had the typical "catch-all" provisions requiring the inclusion of any additional information not otherwise specifically required that could influence "the decision of such holders and potential purchasers to acquire or dispose of securities." Companies were also subjected to something akin to prospectus delivery requirements and the Ministry of Finance had stop-order powers.

Even before the end of privatization, companies began to enter the capital markets and sell shares; voucher funds and banks were initially the most relentless sellers. By 1993, however, operating companies had also entered the market. This process only highlighted the flaws in the organization of the capital markets.

Despite their apparent rigor, the disclosure requirements for offerings were inadequate. In particular, the regulations did not ensure sufficient financial disclosure. Although the regulations required audited financial statements, the information was not particularly useful to investors. Having arisen in a non-market economy, Russian accounting principles did not develop out of a need to provide investors with information necessary to make informed investment decisions, but rather to meet the needs of government, particularly tax, authorities.

In addition, companies developed methods of avoiding much of the more exacting disclosure, most noticeably through the formation of shells. This enabled companies to respond to such requirements as the need to provide three years of financial statements by noting that, from the moment of registration, the company "had conducted no . . . economic

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121 Id. § 27.
122 Id. The provision required that companies "be obliged to make it possible for every buyer to get acquainted with the terms of sale and the issue prospectus before they purchase these securities." Id. A 1994 presidential decree required that advertisements concerning shares include "the date and number of the registration of . . . securities, the place of registration and the place where prospective buyers [could] acquaint themselves with the terms and conditions of the issue." Vedomosti RSFSR, No. 1183, supra note 101, § 1.
123 SP RSFSR No. 78, supra note 42, art. 38. The provision allowed the Ministry of Finance to declare an issue "null and void, to suspend issues or to refuse to register them" upon a finding that the prospectuses contained "unreliable and incomplete" data. Id.
activity." The formation of a shell was not entirely an act of financial obfuscation, but also a desire to sidestep regulatory restrictions, particularly the need for shareholder approval of share offerings.

Although the prospectuses generally observed the express regulatory requirements, they clearly did not comply with the spirit. Prospectuses purported to provide disclosure mandated by the requirements of the regulation, but in reality, investors received little useful information. Moreover, while the regulations embraced the idea that the documents had to include all non-required but otherwise relevant information, issuers all but ignored the provision.

The All-Russian Automobile Alliance ("AVVA") prospectus illustrated the meager disclosure made during the offering process. Although filed with the Ministry of Finance and conforming to the disclosure regulations, the offering document contained no specific discussion of the use of proceeds, true risks of the investment, the time frame for when automobile production would begin, and the controlling shareholders of the shell company.

Finally, the disorganized market made the use of registered share certificates unappealing, resulting in solutions that

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125 Regulation 601 requires shareholders to approve, by simple majority vote, any "increase [in] the charter capital." Regulation 601, supra note 6, art. 39. Moreover, the regulations of the Ministry of Finance likewise repeat that shareholder approval of an increase in capital is a precondition to an offering. See supra note 108. By forming a shell, presumably only the shareholders of the shell needed to approve the offering, turning the requirement into a formality. In the United States acquiring companies usually form subsidiaries to effectuate mergers for the same reason.

126 With respect to production, the prospectus noted that "[a]ccording to a tentative forecasting, the volumes of export of VAZ-1116 [model] may be as high as 50% of annual production." AVVA PROSPECTUS, supra note 124, at 6. The document, however, contained no information on expected production, no detailed discussion of the VAZ-1116 model, and no backup information supporting the projection. There was also no discussion of the particular export markets where the cars would be sold or the nature of the competitive conditions that would exist. The prospectus simply noted that the "world market" showed a "continuously rising demand for" the vehicles. Id.
further diminished the rights of shareholders. In place of certificates, companies sold receipts or other types of bearer instruments that could be converted into shares. Holders of these receipts received the economic, but not the substantive, benefits of ownership. They were entitled to dividends, but could not vote at shareholder meetings.

The instruments arose in part because of difficulties associated with the transfer and settlement process, particularly problems of ownership registration. Bearer instruments meant that resales could occur without having to register the ownership interest, thus reducing some of the counter-party risk. They also, however, effectively disenfranchised investors, allowing management to retain complete control. Companies went to great lengths to discourage conversion. In at least once instance, management attempted to minimize the exchange of receipts for shares by allowing receipt holders to participate in lotteries for free cars.

Stock certificates made sales more difficult. Even after a buyer paid for the shares, significant delay often occurred in the registration of ownership. Investors therefore had to provide payment, but, for a period of time, received no indicia of ownership. During this time, they would receive no dividends and were unable to sell the shares (although they could sell options in the expectation future delivery would occur). Bearer instruments sidestepped the problem. The use of bearer instruments permitted outside investment without dilution of control. See infra note 128.

They could not sell bearer stock certificates under Regulation 601. The issue of "receipts" convertible into shares avoided the limitation. See Regulation 601, supra note 6, § 57.

Shares had to be available for conversion. Nonetheless, Russian law did not permit authorized but unissued shares. Some companies solved the problem by issuing the shares to agents (i.e. management) and allowing them to vote the shares until conversion took place. See AVVA PROSPECTUS, supra note 124, at 4-5. As a result, those companies effectively gave management voting control without the need to provide capital.

The sale of a share required a cash payment. Even after payment, however, the interest had to be recorded in the company registry. Brokers in outlying areas would often communicate with a company, or a company's registrar, on an infrequent basis. The party that paid for the shares would receive no ownership rights (including the right to the payment of dividends) until the registration process had been completed. By purchasing a bearer instrument, ownership transferred immediately. While the purchase of the instrument did not provide any rights as a shareholder, it did immediately provide the right to the economic attributes of ownership.

This was the approach used by the Automobile All-Russia Alliance, or AVVA. See AVVA PROSPECTUS, supra note 124, at 5 (noting that the
5.2. Limitations on the Distribution Process

Disclosure was only part of the problem. Companies undertaking a public offering needed a distribution system for the shares. Distribution in other industrial countries typically involved a network of brokers that could place the shares with its customers. Broker networks sufficient to place a large scale offering in Russia did not, however, exist.

In the absence of a sufficiently developed market to handle primary distributions, each company had to find its own method of selling shares. To spur demand, companies often resorted to high-profile advertising, including print advertisements and television commercials. The statutes governing advertising provided only that the funds could not "promise positive returns to investors or ... promise to redeem shares ...." The issuance of shares was also expensive, with one market participant estimating that costs accounted for ten to twenty percent of the value of each issue.

This did not mean a broker-free distribution process. In fact, companies often used a particular broker, or group of brokers, to act as selling agents. To the extent other

right to participate in the automobile lottery "is annulled after the certificate has been exchanged for that of a certain number of shares").

The government had almost no regulations governing advertisements. Companies simply could not advertise securities "in mass media before the registration of the relevant issue prospectuses in the Ministry of Economics and Finance." RSFSR No. 78, supra note 42, Item 39. See also Vedomosti RSFSR Issue No. 1233, Item No. 8 (1994) (prohibiting advertising campaigns concerning public issues prior to the registration of the issue prospectus). Similarly, while the civil code contained the concept of tortious liability, its applicability to the securities markets was surrounded by doubt.

SP RSFSR No. 1186, supra note 64, at Supp. No. 2, Item No. 43. MMM Investment Fund is a particularly apt example. The fund flooded Russian television with short commercials, ranging from a retired woman extolling the virtues of investing, to pictures of growing stacks of money. The Fund promised returns of no less than 2000% to 3000%. See, e.g., Back From the Grave, ECONOMIST, Sept. 10, 1994, at 88. For a discussion of the Fund and some of its interaction with Russian civil authorities, see Will the Fund's Bubble Burst?, MOSCOW TIMES, June 9, 1994, at 14.


The offering by Doka-Khleb (Doka Bread) included a group of brokers organized by the lead manager, Novy Soyuz. Each member of the group received a quota of shares to sell. To encourage the brokers to meet their

https://scholarship.law.upenn.edu/jil/vol15/iss4/1
brokers wanted shares to sell, they had to contact a selling broker and acquire the shares directly, cash on delivery.\footnote{136} Consequently, brokers located in distant regions had to fly to Moscow with the necessary funds. Given the difficulties with payment transfers in the banking system, this meant physically transporting cash. They returned with bearer certificates or other documents representing ownership.\footnote{137}

The sale of shares issued by AVVA represented the first significant national offering and highlighted the problems with the distribution process. To market the shares nationally, AVVA had to hire a share depository, a selling agent to receive payments in each region.\footnote{138} The depository retained an inventory of share receipts,\footnote{139} which the agent sold pursuant to a standardized contract provided by AVVA. The bank acted as the cashier. Once AVVA was informed electronically of the signing of the contract and the deposit of the purchase price in the bank,\footnote{140} the depository would be instructed to release an appropriately numbered receipt.

This system was functional but time consuming and impersonal. First, AVVA had to enter into separate quotas, the company provided, among other enticements, prizes, such as trips abroad. \textit{See DOKA KHLEB, SHARE PROSPECTUS (1994) (on file with the Journal).}

\footnote{136} Brokers often targeted unsophisticated investors. They would set up “fund shops,” which were offices that sold the shares of the largest and most broadly advertised companies. Movie theaters were favorite locations for the shops, attracting large groups of people.

\footnote{137} In this sense, the brokers were dealers, risking their own capital until the shares could be resold. In a more developed market, this would entail considerable risk, particularly given possible shifts in share prices. In Russia, however, this was less risky. With no secondary market, brokers did not have to worry about sudden price fluctuation and, with no price disclosure, they did not have to worry about small spreads. The only real risk was that brokers would be left without a buyer because demand would be insufficient. By the summer of 1994, some Moscow brokers had opened sales offices in other cities, such as Nizhny Novgorod. These offices did little, however, except sell shares of widely advertised companies.

\footnote{138} Although conceptually distinct, particular entities sometimes had overlapping tasks. A bank could, for example, act both as a depository and as a bank.

\footnote{139} AVVA did not sell registered shares, but receipts that could be converted into shares. The offering, however, had built-in disincentives to conversion. \textit{See supra} note 128.

\footnote{140} The purchase price was deposited typically by electronic mail, although in some instances it was done by phone.
agreements with each party involved. Second, companies seeking to use a similar arrangement had to create their own network with their own agreements. Despite its drawbacks, however, the system facilitated national distribution and avoided the need of regional brokers to fly to Moscow to obtain inventory.141

Anecdotal evidence suggested that the typical purchasers of the shares or receipts, were unsophisticated investors.142 The instruments were sold for cash to anyone who wanted to purchase them. Frequently, brokers did not record the names of the purchasers, indicating that they had little interest in creating permanent customer relationships.

6. ORDER FROM DISORDER: DIFFERENTIATION AND THE DEVELOPMENT OF A SECONDARY MARKET

6.1. The Need for Differentiation

Many of the problems within the Russian financial markets were attributable to, or exacerbated by, the absence of a secondary market. Managers generally had no cause to worry about the effect of their behavior on share prices. Moreover, the absence of trading markets heightened tensions between management and outside shareholders. Low share prices, enabled investors to purchase large blocks of share and successfully oust management. Consequently, managers grew wary of outside shareholders and free-trading shares.

Most noticeably, however, the absence of a secondary market impaired the capital raising process. Shareholders could not rely on the possibility of appreciation and resale to achieve the necessary gain. Dividend rates, therefore, were the primary basis for obtaining a return. This gave an advantage to companies promising high returns, while putting pressure on others to pay out earnings to shareholders instead of reinvesting them in the business.

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141 With depositories physically located in the region, brokers did not have to expend their own capital to acquire inventory. In this sense they did not act as dealers. The burden was on AVVA to ensure that each regional depository had an adequate supply of inventory.

The development of a secondary market was therefore critical to the capital raising process and to modify management’s behavior. The creation of such a market, however, was no easy task, requiring the development of an organized system for differentiating among brokers and issuers.

Broker behavior was largely unregulated. A broker had to obtain a license, from the Ministry of Finance.\textsuperscript{148} To obtain the license the broker merely had to include certified specialists on its staff, comply with minimal capital requirements, and adhere to certain accounting provisions.\textsuperscript{144} This regulatory regime did not mandate price disclosure and basic rules of behavior. Moreover, although the Ministry of Finance theoretically had the power to revoke licenses in certain circumstances, it rarely did so. Given the absence of behavioral rules and price transparency, investors lacked the necessary information to determine which brokers would most likely act in their best interests.

Similarly, the market contained an undifferentiated class of issuers. Legitimate companies had few ways of signaling to potential investors that they were, in fact, financially sound investments.\textsuperscript{145} Disclosure standards were almost nonexistent. In addition, these companies had to compete with less reputable firms that used aggressive advertising techniques to sell shares.\textsuperscript{146}

\textsuperscript{148} See SP RSFSR No. 78, supra note 42, Item 21.
\textsuperscript{144} See id. Item Nos. 23 & 30.
\textsuperscript{145} The prospectus for Doka Khleb (Doka Bread) disclosed that the company wanted to manufacture and sell mini-bakery units and pizzerias. DOKA KHLEB, supra note 135, ¶ 12. The prospectus contained a relatively insightful discussion about the bread industry in Russia and the need for smaller, more flexible manufacturing units. Id. ¶ 28, § 1.2. The document included details on the use of proceeds, the volume of production from the mini-bakeries, and the estimated sale price of the units. Id. § 2. In addition, the prospectus contained three risk factors, including “the undeveloped state of the Russian stock market.” Id. ¶ 29. Nonetheless, despite the disclosure, pertinent information was still missing. The Doka Khleb prospectus contained no financial disclosure or information about SRC Doka-Pizza, the controlling shareholder. Moreover, besides noting that the design for the ovens had been under development at SRC Doka-Pizza for two years, id. ¶ 28, §1.1., the document contained little specific information about the principal product to be sold by the company.
\textsuperscript{146} This begs the difficult question of adequate disclosure, particularly in connection with financial disclosure.
Serious investors did not have any easy way to distinguish among companies. Due to the generally low level of disclosure, adequate financial information on companies rarely existed. In addition, brokers did not act as adequate filters. Often brokers were less concerned with the underlying value of shares than with their ability to induce unsophisticated investors to make purchases. The system made it difficult for retail investors to participate in the securities markets. Only the largest investors had the time and resources necessary to conduct their own independent investigations of particular companies.

The market, therefore, needed to provide mechanisms that would, to some degree, distinguish issuers and reduce the transaction costs for investors. Increased disclosure represented the best mechanism for accomplishing these goals. In the case of brokers, disclosure meant transparent price information. In the case of issuers, it meant the availability of relevant financial information. Neither would occur as the result of legal reform but only after the parties appreciated the benefits that flowed from the heightened disclosure.

6.2. Disclosure

6.2.1. Issuer Disclosure

Issuer disclosure fell into two categories. The first type involved the offering process. This required improvements in the contents of the prospectus used in the distribution of shares. Although detailed regulations existed, they had little

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147 See, e.g., The Eighth Sister, ECONOMIST, Oct. 15, 1994, at 93 ("Gazprom ... publishes no accounts. In part this reflects traditional Russian secrecy, in part the fact that its corporate structure is so vague that it is hard to present consolidated accounts.").

148 At a Moscow meeting of the selling group for Doka-Khleb in June 1994, the brokers showed little interest in the operations of the company and were more concerned with the amount of advertising designed to increase investor interest. Brokers sometimes had access to non-public information about the operations of client companies. Accordingly, they could provide some degree of guidance on distinguishing good for bad investments. In general, however, they did not provide this type of information to ordinary retail investors. Moreover, it was always difficult to determine whether a recommendation was based on the broker's perception about the future of the company or a desire to promote a corporate client.
real teeth and resulted in little useful disclosure.\textsuperscript{149} The Ministry of Finance reviewed and approved prospectuses, but seemed to exercise minimal oversight of their contents.\textsuperscript{150}

The second category involved continual disclosure to the market. Companies were already required to update the market on a regular basis.\textsuperscript{151} For example, Regulation 601 required joint-stock companies to "publish quarterly and circulate to stockholders the balance sheet of the society, the profit and losses account, and other current information."\textsuperscript{152} The regulation, however, contained few specifics about how to disseminate the information or the contents of these reports. A presidential decree addressed the issue in June 1994.\textsuperscript{153} The decree required open joint-stock companies who traded their shares to publish quarterly financial information in "the popular press."\textsuperscript{154} The edict specified that the information had to be published in a particular type of printed medium and freely distributed throughout the territory where the company was registered.\textsuperscript{155}

These dissemination requirements had little utility absent a mechanism for ensuring an adequate level of disclosure. In the context of both primary offering and secondary trading disclosure, the system lacked qualitative standards designed

\begin{footnotesize}
\begin{enumerate}
\item[149] See supra note 126.
\item[150] This explains a company's ability to use shells when making a public offering. See supra notes 125-26 and accompanying text. A completely different issue was the reform of financial disclosure and the development of more market-driven accounting standards. See discussion infra § 5.1.
\item[151] The same concern arose during the development of the U.S. securities laws. The Securities Act of 1933 provided for mandatory registration of public offerings. See 15 U.S.C. § 77a, et seq. The Act, however, was criticized for not providing continual disclosure to the investing public, one of the principal goals of the Securities Exchange Act of 1934. See 15 U.S.C. § 78a, et seq.
\item[152] Regulation 601, supra note 6. Companies also had to disclose, within two months after the holding of the annual meeting, "the annual report and balance sheet" in a form determined by the Ministry of Finance. See id. Item 87.
\item[153] Id. at Item No. 6.
\item[154] Id. at Item No. 6. The Decree specifically required the disclosure of balances and profit-loss accounts. Id.
\item[155] Id. Item No. 6. For companies with more that 5000 shareholders, the medium had to have a circulation of at least 50,000 and be freely distributed throughout the Russian Federation. Id. at art. 7. The precise publication was to be determined by the company's board of directors. Id.
\end{enumerate}
\end{footnotesize}
to maximize the usefulness of the information to investors. The existing regulatory regimes would have little impact until effective standards were developed.

For qualitative standards to arise, however, demand had to exist in the market. This meant that dynamics in the market had to exist to promote proper disclosure. Investors had to appreciate and want the information and companies had to see the benefits of disclosure.

6.2.2. Price Disclosure

Brokers in Russia did not disclose price information on a current basis. In most emerging markets, stock exchange rules dictated disclosure requirements. An exchange, in its simplest form, involved a centralized place for bringing together buyers and sellers, with public reporting of trades in the securities of listed companies. In addition, exchanges also regulated broker behavior by the creation of basic obligations toward investors, reporting requirements, and mechanisms for monitoring broker behavior and enforcement of the rules.

Exchanges in Russia did not, however, play this role. By presidential decree, the Ministry of Finance was granted the authority to license exchanges. Exchanges were required to be established in the form of a closed joint-stock company owned exclusively by members. Under Ministry rules, the exchanges had to create provisions governing membership and qualifications for members. In addition, the licensing procedures contemplated the use of listing standards, to be developed by the exchange in agreement with the Ministry of Finance.

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156 Some brokers did advertise bid and ask prices in the mass media. There was no guarantee, though, that the broker would abide by the prices. Instead, the advertisement often included attractive prices to induce inquiries and allow the broker to obtain additional customers.

157 This leaves aside the market maker/specialist function, which is primarily to ensure stability by providing additional, temporary liquidity to the market.

158 See SP RSFSR no. 78, supra note 42, art. 55. They were to be organized as a non-profit organizations. See also id. art. 57 (requiring registration with the Ministry of Finance).

159 See id. arts. 61 & 62.

160 See id. art. 64. The regulations issued by the Ministry of Finance...
The combination of loose requirements and ease of obtaining a license led to the proliferation of stock exchanges. At one point, Russia had over 120 exchanges. As recently as the summer of 1994, Moscow still had four: the Russia Stock Exchange, Moscow Central Stock Exchange, Moscow Interbank Currency Exchange, and the Moscow International Stock Exchange. More significant than the number, however, brokers did not execute trades over the exchanges in any appreciable quantity. 161

Not all exchanges, however, operated in a haphazard or random fashion. In Novosibirsk, a major center in Siberia, for example, the Siberian Stock Exchange or Sibex engaged in a deliberate effort to consolidate exchanges. Formed in February 1991, Sibex had, by the summer of 1994, absorbed most of the other major Siberian stock exchanges. Sibex established listing standards for issuers, 162 rules governing specialists, and provisions for members. 163 The exchange also developed standardized contracts for the sale of both stocks and options, held educational programs for its members, and imposed prohibitions on insider trading by its employees.

Despite these efforts, Sibex suffered similar problems to those that occurred at other exchanges throughout Russia. While items traded on the Sibex exchange included stocks, bank credit, foreign exchange and futures (primarily on foreign exchange and vouchers), vouchers transactions constituted the bulk of its business. The exchange executed only a small

largely fleshed out the system. The rules of the exchanges had to include, among other requirements: (1) the submission of price information; (2) the compulsory publication of information on companies listed on the exchange, (3) the prevention of “dishonest transactions,” and (4) the rights and obligations of exchange members. See Id. § 6.

161 Interestingly, in a number of regions, exchanges did bring together buyers and sellers. Brokers would often travel to the physical location of the exchange where they could determine the inventory of other brokers and engage in trades. The trades were not, however, reported to the exchange or made public.

162 Only one small exchange in Western Siberia continued to operate. In Eastern Siberia, Vladivostok was the only other potential financial center with stock exchanges unabsorbed by Sibex.

163 Among other requirements, the listing standards called for issuers to provide mandatory disclosure to Sibex on a quarterly basis and in a condition acceptable to the exchange. Issuers also were required to inform Sibex of forthcoming changes in the company which could alter the quality of the securities.
number of equity trades.

Thus, the exchanges played a minor role and remained largely irrelevant to the emerging secondary markets. Because of the absence of effective exchanges, the reporting of share prices in the secondary market often did not. Listing standards that elevated corporate behavior, particularly through increased financial disclosure, did not exist. In general, brokers profited from the opaque markets. Investors did not know the price paid by the dealer and did not know the mark up charged on the transaction. Companies also profited because an opaque market could obscure their true financial condition, thereby reducing the risk of a hostile acquisition attempt.

7. THE CATALYST FOR REFORM AND THE ORGANIZATION OF THE MARKETS

Exchanges were not going to provide the structure necessary for organized securities markets. Nor would this occur through legal reform. Russia already had a tolerable, if not acceptable, legal infrastructure covering securities transactions. Consequently, establishing order would mean assisting the dynamics which were already emerging in the markets. Some brokers and companies, for instance, were already seeing the benefits of differentiation and disclosure, something that could be facilitated with additional assistance.

7.1. Overview

Increased information would facilitate the development of the securities markets. Investors would have a basis for distinguishing among companies and brokers without having

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164 Exchanges were required to publicize price information. To avoid this reporting requirement, brokers generally did not make trades over the exchange. See supra note 154 and accompanying text.

165 Markups should be distinguished from transaction costs. Brokers in outlying regions who wanted to sell shares of a Moscow issue had to physically travel to Moscow and use their own funds to make purchases. These transaction costs would be passed on to investors in the form of higher prices. Markups, on the other hand, were increases in price due to the absence of transparency and the lack of information that would enable investors to know that they could obtain the shares elsewhere at a lower price.
to perform time-intensive and expensive investigations. This, in turn, would promote confidence, facilitate investment, and increases market liquidity. While a relatively uncontroversial goal, the means of increasing the amount of information remained the principal uncertainty.

Stock exchanges were not the answer. In other emerging markets, stock exchanges typically handled the function of price disclosure and, to a lesser extent, corporate disclosure. The stock exchanges regulate brokers and ensure that transactions are properly reported. With respect to issuers, listing standards impose a high level of disclosure, particularly financial. The absence of one national exchange, however, prevented the successful development of a similar arrangement in Russia.

Nor would reforms likely flow from government initiatives. First, the existing bureaucracies had shown little understanding of the operation of the securities markets. The government did not encourage the use of central trading markets and, in fact, adopted policies that discouraged their use. The Ministry of Finance imposed a tax on stock transactions conducted over the exchanges, thereby contributing to the flow of business into the OTC market.

Similarly, government oriented solutions were likely to stunt the development of the securities markets. In the aftermath of financial scandals such as MMM, government proposals sometimes surfaced that seemed designed to protect investors from their own folly. They contemplated limits on the number and type of companies that could sell shares or on the types of institutions that could buy them. In short, this meant a form of merit regulation.

The Moscow Interbank Currency Exchange or Micex, the currency exchange, illustrated the problems that could arise. The City of Moscow had some independent authority to impose

166 This was true in the emerging markets of Eastern Europe. Poland, Hungary, and the Czech Republic, all had central stock exchanges that imposed rules of behavior on their members.

167 While not completely clear, the use of exchanges raised some political considerations. Licensed by the Ministry of Finance, the exchanges were sometimes owned in part by the government. The people operating the exchanges often had connections to the government or to government officials. The exchanges' commitment to a more openly traded market was therefore sometimes suspect.
taxes. Recognizing the high level of trading taking place on Micex, the mayor of Moscow imposed a tax on transactions, causing volume on the exchange to plummet.\textsuperscript{168} A centralized stock exchange would have provided intrusive bureaucracies with a similar target.

Indeed, the most obvious government agency that could have brought some degree of order to the markets—the Ministry of Finance—did not demonstrate the requisite level of skill or commitment to make the requirements work. The Ministry had control over the licensing of brokers and exchanges and over the review of prospectuses but resolutely failed to use its authority to establish reasonable standards.\textsuperscript{169}

Finally, even if the government had issued the appropriate edicts, there is no reason to believe that they would have been followed. In a number of instances, the President issued decrees designed to affect company practices. These decrees included requirements to use independent registrars and prohibitions on excessive advertising. Neither, however, seemed to have had the intended effect.\textsuperscript{170}

7.2. The Market Solution

Presidential decrees or Duma-adopted laws, therefore, would not solve the market's disorder. Enhancing the authority of the bureaucracy would similarly be ineffective. Only by encouraging market forces already in place would the markets become more transparent and effective. For a market

\textsuperscript{168} Exchange Cuts Charges, MOSCOW TIMES, July 1, 1994.

\textsuperscript{169} Despite its authority, the Ministry of Finance did not take proactive measures in the market and, as a result, little enforcement occurred. Brokers receiving licenses had little fear of revocation. Prospectus reviews did not result in meaningful disclosure standards. Therefore, enhancing the Ministry of Finance's oversight seemed unlikely to bring much additional order to the market. In addition, the Ministry of Finance may have had motives inconsistent with an open market. Because banks represented a strong interest group, the order imposed on the market may have been designed more to meet the banks' needs than to facilitate trading.

\textsuperscript{170} See, e.g., Mikhail Dubik, Enforcers Vow To Target Fraudulent Ads, MOSCOW TIMES, July 6, 1994, at 11 (discussing comments made by Natalya Fonaryova, Deputy Head of the State Antitrust Committee who stated that more than 80% of the advertisements for finance and insurance companies were in violation of presidential decree).
driven solution to succeed brokers and issuers themselves had to recognize the need for differentiation and take steps to implement such a process.

By early 1994, this had tentatively begun. Brokers in St. Petersburg and other Russian cities formed associations. These organizations were rudimentary and apparently intended primarily to lobby the government. Nonetheless, they illustrated the growing recognition within the market about the need to differentiate.

The most significant early efforts occurred in Moscow. In the summer of 1994, brokers took affirmative steps toward the organization of a trading association. A group met in late June and early July to devise a charter and create a set of rudimentary rules for the association. By the end of the summer, nascent associations had appeared in other cities.

Self-regulation as a solution to a disorganized market had a number of advantages. First, rules of behavior and listing standards, in short, methods of differentiation, would develop. Second, in a country with many laws but little compliance, standards developed by the market participants themselves had a greater potential of being observed. Third, regulations created by market participants were less likely than a bureaucratic solution to conflict with market development.

At the same time, however, self-regulation posed risks. Standards could be set too low. Meaningful enforcement of an association's rules also raised concerns. Only true

171 The Director of the Property Fund in St. Petersburg initiated these efforts.


173 Organizational meetings took place in other Russian cites. In certain regions, however, brokers did not develop an appreciation for the reasons for organizing, and so did not take any steps in that direction. In some instances, mutual distrust among brokers impeded the development of collective associations.

174 This seems to be a problem that arguably will correct itself over time. Once reasonable differentiation begins, market forces (primarily demand from investors) presumably will insist on stricter standards.
enforcement would give membership and the rules regulating membership behavior substantive meaning. In part, this required adequate authority to penalize violations. It also necessitated the development of a transparent and procedurally sound system for imposing penalties that would give the public both access to and confidence in the process.

In addition, regional trading associations created immediate problems of standardization. As groups began to arise in various regions, no guarantee existed over common standards for all associations. Standardization did not rule out the possibility of variations among associations, but did contemplate the need for a universal base. This provided the investing public with some level of assurance that all association members and listed companies would meet a common, set of minimum requirements.

These problems meant that a role—albeit a limited one—remained for government involvement in the development of the securities markets. This role was likely to fall to the RFCSE, an “independent” agency. “Independent” meant that the organization fell under the supervision of the President, rather than the Prime Minister or Duma.\(^{175}\) The RFCSE officially came into existence in October 1992. In reality, however, formation took much longer, having to overcome considerable political impediments.

Consisting of a “collective body,” members to the Commission were to be affirmed by the President.\(^{176}\) The body had to be composed of representatives from most of the entities that regulated the securities markets, including “the State Committee of the Russian Federation for management of state property, the Ministry of Finance, the State Committee for anti-monopoly policy, the Central Bank, Russian Fund of Federal Property[, and] ... stock exchanges.”\(^{177}\)

\(^{175}\) See SP RSFSR, No. 1186, supra note 64, Supp. No. 2, Item No. 43. The Decree provides that the agency's membership shall include representatives of the Committee for the Management of State Property, the Ministry of Finance, the Anti-Trust Commission, the Central Bank, the Federal Property Fund, and the stock exchanges. Id.

\(^{176}\) Regulations for the Commission on Securities and Stock Exchanges of the President of the Russian Federation § 1.2, aff'd by Exec. order No. 163 (1993).

\(^{177}\) Id. The structure of the Commission was to comprise of the
The regulation provided RFCSE with a thin agenda. Specifically, the agency had the task of devising and enforcing regulations to govern the "issu[ance] and circulation of securities as well as the activity of professional participants of securities market." The RFCSE was also to develop uniform procedures, book-keeping requirements, and accounting rules. Finally, the regulation authorized the agency to adopt rules regulating shareholder meetings.

Although ostensibly assigned to oversee the securities markets, the RFCSE lacked jurisdiction over the participants. The Ministry of Finance, not the RFCSE, had authority to license brokers and stock exchanges, review registration statements, and enforce presidential decrees on advertising. Voucher funds represented the only significant area within the agency's jurisdiction. This limited authority meant that the RFCSE would either have to engage in a bruising battle with existing bureaucracies to extend its authority or find niches not already assigned elsewhere. Oversight of trading associations represented an obvious niche.

The key to successful government involvement was to permit some oversight and, presumably, enforcement without

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Chairman, the Chairman's deputies, the Board, and an Advice Council. The law provided the Chairman with special powers. Id. § 4.3. The Chairman was assigned the task of "manag[ing] the current activity of the Commission" and of assigning duties to deputy directors. Id. The Chairman also had the authority to sign documents issued by the Commission, presumably making his or her assent necessary for official action. Id. The Advice Council was to be an advisory board consisting of securities specialists, including "representatives of state bodies, academic and educational institutions, [and] commercial structures." Id. § 4.5.

Id. § 2.0. The RFCSE, however, was given exclusive enforcement authority. The RFCSE was to "undertake jointly with relevant bodies official investigations aiming to take decisions on sanctions regarding participants of the securities market . . . ." Id. § 3.1.

Id. § 2.0. In particular, the Commission was given the right "to organize the audit of the activity of professional participants of the securities market or to oblige to present audit data." Id. § 3.1.

Originally, GKI had regulatory authority over voucher funds. With privatization ending and the purpose for the GKI coming to an end, the RFCSE was the obvious recipient of that authority. Even here, however, bureaucratic conflict loomed. Since vouchers would largely expire at the end of June 1994, voucher funds would have to sell shares for cash in order to buy shares. In other words, the voucher funds could function as conventional, closed-end funds. Investment funds, on the other hand, were subject to the regulatory oversight of the Ministry of Finance.
creating another large, interventionist bureaucracy. The creation of a sprawling Russian bureaucracy had already occurred when the GKI essentially privatized Russian industry. Given the history of strong central authority in Russia, comparable development in the area of the securities regulation also could not be ruled out.

A small bureaucracy, the RFCSE, and a market-driven mechanism, trading associations, seemed to represent the best method for bringing order to the Russian securities markets.\textsuperscript{181} Adopting this approach, however, had certain negative consequences. As the market continued to develop and organize, a high level of abuse would naturally occur which, in the short term, no amount of legal reform could prevent.

8. CONCLUSION

This Article is designed to accomplish a number of goals. On one level, it simply conveys a snapshot of the development of the Russian securities markets, which is a constantly changing and dynamic process. The same article written a year from now will no doubt describe a very different stage of development, particularly as the process of voucher privatization recedes further and further into the past.\textsuperscript{182}

On another level, this Article asserts that legal reform will not be a successful mechanism for imposing greater order on the securities markets, at least as long as the efforts remain divorced from the economic forces behind the market's behavior. Legal reform only becomes effective when participants identify the ways in which the current market does not adequately protect their interests and when participants become sufficiently organized and motivated to alter the existing dynamics.

This simple proposition, however, carries with it some unappealing baggage. Legal reform -- whether mandatory disclosure requirements or more coherent corporate laws -- will

\textsuperscript{181} Best, here, connotes the least destructive.

\textsuperscript{182} This is not to say that the government's role in disposing of businesses has ended. Property funds must still sell their residual shares, which constitutes a considerable portion of the market. In addition, privatization has proceeded slowly in some areas, particularly in Moscow.
not bring order to the markets. Stepped-up government enforcement likewise will not significantly change market behavior but will make the bureaucracy partisan participants in the existing divisions.

Similarly, abuses and unfair practices are likely to continue and indeed, are a necessary part of the development of organized securities markets. The collapse of MMM did more to educate Russian investors about the need for adequate information than any government inspired program. By causing investors to agitate for information changes designed to better protect their interests, companies will gradually learn the relationship between disclosure and the capital raising process. Only when that occurs will the day of reckoning mentioned by Vasiliev take place. At that point legal reform will become far more relevant, primarily as a tool used by interest groups to effect change in the market.

This suggests that scandals and abuses represent normal and, indeed, valuable components in the evolutionary process of the securities markets. They provide an educational function by illustrating the value of standards that separate various classes of companies and brokers to ordinary investors. Without these educational features, no amount of legal reform or affirmative government policy will eliminate the undesirable practices.

The danger in Russia is that the presence of scandals and the failure of legal reform will induce a heavy-handed governmental response in the name of investor protection. In the summer of 1994, rumors swirled in the securities markets that the government was considering a decree that would prohibit securities trading except through licensed banks; essentially, this would eliminate brokers as a distinct class of intermediaries.

Attempts to impose order through government fiat will work no better than existing legal methods to control the securities markets. Instead government fiats will hinder the development of the securities markets. In an effort to circumvent such governmentally-imposed limitations, the markets will evolve in an inefficient direction. Overall,

\[183\] Indeed, it may well be the case that the organizational efforts by brokers are, in part, designed to distance themselves from disreputable segments of the securities markets.
however, despite all of their disorganization, the Russian securities markets are moving in the right direction and should be allowed to continue with the least amount of interference.