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INTRODUCTION

The question in the title of this article is not necessarily rhetorical. Perhaps a more appropriate inquiry is, does Russia need its current securities law?¹ The response to the titular question is, as I will argue, clearly yes. The answer to the second question is to a large extent negative. Given the prevailing economic conditions in Russia, the course of enterprise privatization, and the principal institutions shaping Russian capital markets, there is good reason to think that rather than assisting the growth and entrenchment of a market in securities, much of the current Russian securities legislation will be superfluous and possibly hinder such growth.

The voucher privatization process, which the Russian government undertook during 1992–1994, was an attempt to create broad-based equity ownership in formerly state-owned firms.² Once vouchers had been distributed to "every man, woman and child in Russia,"³ the privatization plan established voucher auctions that enabled individual investors to exchange their vouchers for pools of shares side-by-side with large institutional stakeholders, such as voucher investment funds.⁴ The 1996 Securities Law,

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³ Id.

meant to regulate the resultant securities market, seems rooted in several assumptions. First, voucher privatization will actually produce widespread share ownership among the Russian citizenry on an individual investor level. Second, even if (as is actually the case) such diffuse ownership of the Russian corporate sector does not materialize, the preferred way to create an active securities market, comparable to the markets in the United States and England, is to emulate U.S. means of securities regulation. In Russia's case, the favored regulatory framework appears to be based on the U.S. Securities Act of 1933 ("1933 Act") and U.S. Securities Exchange Act of 1934 ("1934 Act").

I posit that current assumptions underlying the securities regulation regime established by the Russian government and its Federal Commission for the Securities Markets ("FCSM") are unjustifiably optimistic both as to the prospect of a U.S.- or English-style securities market taking root in Russia and as to the relevance and utility of a U.S.-style securities law in its absence. During the 1930s, the U.S. Congress adopted a federal regulatory regime based on copious disclosure and civil as well as criminal enforcement through judicial and administrative channels. At that time, the U.S. Congress was able to take much of the necessary institutional foundation of such a regime for granted. In Russia today, the situation could not be more different. A judiciary reared on Soviet-era laws, the embryonic state of the market and security ownership, the inadequate resources provided to the

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5 See 1996 Securities Law, supra note 1, art. 1. The 1996 Securities Law actually aims to regulate "the relations arising at the issue and trading of issued securities ... and also the specifics in the creation and activity of professional market participants in the securities market." Although "issued securities" are by definition "placed in issues," see id., art. 2, and do not, at least on their face, include shares purchased with privatization vouchers, the 1996 Securities Law assumes that the privatization process has produced a securities market in which Russian issuers are willing to issue shares to both small and large investors who, in turn, are willing to purchase them. Both the 1996 Securities Law and the Federal Law on Joint-Stock Companies (Federal'nyj Zakon ob Aktsionernyh Obschestvakh) No. 208-FZ (1995), published in Ross. GAZETA, Dec. 29, 1995, at 1 [hereinafter Joint-Stock Company Law], provide regulations for the protection of shareholders without regard to the origin of their shares.

6 A study of Russia's privatized companies by the Russian Federal Commission for the Securities Market has found that outside shareholder ownership of Russian companies is small, fragmented, and on the decline, with only 17% of enterprises owned by outside investors. See John Thornhill, Biting the Bullet, FIN. TIMES, Sept. 6, 1996, at 10. A separate survey reports that only 11% of all privatized companies are majority-owned by outside investors with sufficiently large stakes (5% or more) to influence the management or restructuring of such companies. See The Rooks Have Come, ECONOMIST, July 12, 1997, at 17.

9 See infra Part I.B.
10 See infra text accompanying notes 51-54.
FCSM, and the growth of commercial banks as the financial hubs of very large industrial groups produce a vision of the Russian securities market sharply at odds with the one contemplated by the 1996 Securities Law.

Assuming the incompatibility of a U.S. regulatory heart with a Russian market body, one alternative framework for securities regulation in Russia is a self-enforcing model described by Professors Bernard Black and Reinier Kraakman. Their model, while applied specifically in the context of the Russian Joint-Stock Company Law, takes into account a large number of factors peculiar to the Russian legal and economic landscape that are highly relevant to any chosen regulatory structure for Russian securities. Because the Joint-Stock Company Law and the 1996 Securities Law share many interlocking provisions and seek to regulate jointly much of the same economic terrain, the dissonance between their respective assumptions could not be more striking. Thus, a portion of this article looks at the 1996 Securities Law through the prism of the Black and Kraakman self-enforcing model and queries whether this vision should become reality.

Part I of this article examines the Russian securities market as it has developed up to the enactment of the 1996 Securities Law. Where possible, it traces some parallels to the market conditions and problems that preceded the passage of the U.S. 1933 and 1934 Acts. Part II introduces the 1996 Securities Law, as well as subsequent decrees by the President of the Russian Republic and by the FCSM on the further development of the securities market. It asks whether reconciliation between the discordant regulatory philosophies underpinning the Joint-Stock Company Law and the 1996 Securities Law is possible or desirable. Postulating that the reconciliation of regulatory approaches is not only desirable but also essential for the establishment of a vibrant Russian market in securities, Part III explores an alternative regulatory system which might achieve this goal without the corner-cutting that has grafted a full-blown U.S.-based system of disclosure and regulation onto the nascent and as yet under-developed Russian capital markets. Part IV concludes with a review of the limits of such a system.

I. THE MARKET AS UNCHARTED ZONE

In 1995, the U.S. President and CEO of Renaissance Capital, an investment fund operating in Russia, proclaimed, "[t]here is [in Russia] no proper domestic market infrastructure, no audited financial statements from Russian companies and what’s more, very little interest in compliance by

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11 See infra text accompanying notes 80–82.
12 See infra Part I.C.
14 Joint-Stock Company Law, supra note 5.
15 See infra Part III.
the Russian corporate community."\textsuperscript{16} Concurrently, another observer predicted that "[t]he capitalization of the Russian equity market will be larger than all the markets in Latin America within five years time."\textsuperscript{17} Such varying views are to be expected in a country undergoing the largest national privatization program in history, the assimilation of a democratically elected government and judiciary system under a constitution just over four years old, and the adoption of a legal system at odds with every preceding law over the last seventy-five years.\textsuperscript{18} The unprecedented nature and scale of such changes make predictions on the basis of "all other things held equal" almost impossible. Particularly in the areas of Russian corporate and securities regulation, Russian lawmakers and Western advisors face a kind of legal Heisenberg Uncertainty Principle\textsuperscript{19}: those tracking the Russian capital markets see changes that render contemplated regulatory regimes inappropriate even before they are reduced to laws; those observing the progress of legislation, on the other hand, observe the painstaking construction of a latticework for projected structures and institutions which the market stubbornly refuses to adopt or accept.

The obstacles Russia faces in creating a dynamic and viable securities market are numerous, but several broad areas are particularly significant. First, to the managers of a majority of the enterprises privatized over the past four years, the concept of shareholder rights and fiscal responsibility is either foreign or hostile, and frequently both.\textsuperscript{20} In part, the hostility is justifiable because seventy years of socialism destroyed even vestigial concep-
tions of managerial accountability or fiduciary duty, and managers must now readjust to new power hierarchies. However, managerial animosity toward outsiders is only partially to blame for the opacity in the financial information supplied by Russian firms to actual and potential investors. Other equally instrumental potential reasons for informational deficiencies are the prospect, again carried over from the Soviet era, of personal gain at the expense of the State, and evasion of astronomically high tax rates on businesses.

The second obstacle is the inadequacy of judicial and administrative means to check or punish fraudulent transactions on the market and other violations of established laws. In light of the important role played by policing and enforcement through criminal and civil actions in the U.S.

21 See Cheryl W. Gray, In Search of Owners: Privatization and Corporate Governance in Transition Economies, WORLD BANK RES. OBSERVER, Aug. 1996, at 179, available in LEXIS, World Library, Allwld File (“[S]ocialism inhibited (indeed, often classified as illegal) the development of basic norms and ethics of market conduct and fiduciary responsibility on which so much behavior in advanced market economies implicitly rests.”). The black market, rampant during the Communist era, was hardly a reservoir of ethical market conduct. See also Rupert Gordon-Walker, Taming Old Russian Bears, EUROMONEY (Sept. 1996) <http://www.emwl.com> (citing one western observer to say: "Control is everything. . . . Managers behave like owners now because that was how they behaved and were expected to behave in Soviet times. It is important to have an historical perspective.").

22 See The Challenges of Raising Capital for Russian Companies through ADRs, EAST/WEST EXECUTIVE GUIDE, Oct. 1, 1996, available in LEXIS, World Library, Allwld File [hereinafter Challenges of Raising Capital] (“Even with audits, disclosure will be truncated until the Government of the Russian Federation enacts a modern tax code that invites tax compliance, not evasion, thus facilitating disclosure.”); Scott Studebaker, Russia and Foreign Investors, the View Beyond the Elections, EAST/WEST EXECUTIVE GUIDE, May 1, 1996, available in LEXIS, World Library, Allwld File (“With many Russian companies, if they are trying to hide something, it is not necessarily from investors, but from the Russian tax authorities. Many companies have two sets of books: one for foreign investors or major investors, and another for Russian tax authorities.”); Lee, Russian Winter, supra note 16 (“Few Russian companies are open about their results, their profitability, even what other companies they own, for fear of being hit with high tax demands from the government.”).

Regarding the uncertainty and unpredictability of the Russian tax system for foreign investors, see David F. Black, So Do You Want to Invest in Russia? A Legislative Analysis of the Foreign Investment Climate in Russia, 5 MINN. J. GLOBAL TRADE 123, 141–148 (1996).

23 With respect to courts, their inefficacy at resolving commercial disputes stems from their grounding in Soviet laws and legal methods. See Gray, supra note 21 (During the Soviet era, “[I]egal frameworks defining property rights, private contract regimes, fiduciary liability, dispute resolution mechanisms, and rules of entry and exit for private firms atrophied. Courts lost much, if not all, of their independence as well as their role as adjudicators of commercial disputes and enforcers of commercial laws.”).

More recently, it has been noted that the FCSM “lacks the enforcement power enjoyed by its Western counterparts in respect of conducting investigations and in levying fines and penalties on wayward market participants.” Yuri Golovanov, Issues in Russia’s Emerging Securities Market, E. EUR. BUS. L., Nov. 1996, available in LEXIS, World Library, Allwld File. See Lee, Russian Winter, supra note 16, at 52 (“The Russian SEC is good at producing regulations but has almost no capacity to enforce them or penalize recalcitrant companies.”).
conception of securities regulation, the deficiency of judicial and administrative institutions in Russia threatens to render impotent the elaborate regulatory structure of the 1996 Securities Law.

Finally, a strong and well-financed commercial banking sector has grown up alongside a comparatively weak and disorganized pool of securities firms. At least one observer has argued, with good reason, that absent decisive regulatory intervention, Russia will develop a bank-dominated system, similar in various respects to the German and Japanese models. As a consequence, Russia runs the danger of failing to develop strong domestic capital markets and therefore facilitating government intervention in the market.  

The regulatory model espoused by the 1996 Securities Law risks catalyzing this process by ignoring its evolution and imposing the right sort of regulation for the wrong market.

A. Russian Corporate Management: Learning by Doing

Privatization in Russia has produced two adversarial forces in the arena of corporate control. On one side are the institutional investors who demand the right to protect and manage the holdings they acquired during privatization. On the other side are entrenched Soviet-era directors who fight to remain in control of “their” companies, and do not hesitate to use intimidation, personal connections with the Russian government, and outright fraud to achieve their goal. One method used by these directors relies on convincing or coercing employees to place their shares into a long-term trust from which they cannot be withdrawn and through which the management can vote such shares. Other abuses of managerial authority have included the deletion of outside shareholder stakes from company registers and massive unpublicized share dilutions. A notorious example of

25 See Brown, Brokers, Banks, supra note 24, at 194.
26 Id. at 220.
27 See Neela Banerjee, Russia to Get Tough With Tax Evaders, WALL ST. J., July 31, 1996, at A10. (“Company revenues are often diverted to lavish projects or to the bank accounts of management, who usually have no powerful shareholders to answer to.”).
28 See Mileusnic, Boardroom Revolution, supra note 20.
29 See Black & Kraakman, supra note 13, at 1951.
30 One particularly vivid example was the 1994 decision by Krasnoyarks Aluminum to delete from its share register the entire 20% stake held by the British Trans World Group. See Mileusnic, Boardroom Revolution, supra note 20; Russian Share Registries Come Under Scrutiny, RUS. & COMMONWEALTH BUS. L. REP., Feb. 26, 1997, available in LEXIS, World Library, Allwid File.
31 For example, the Komineft oil company diluted the holdings of foreign shareholders by delaying for nine months its announcement of an $18 million share increase in its charter
dilution occurred in October 1996, when Surgut Holding announced that it had issued and assumed ownership of 500 million new shares of common stock in its oil operating subsidiary Surgutneftigaz. In the process, Surgut Holding increased its stake in the subsidiary from 38% to 43.5%, at the same time the share price dropped by 17% on the announcement date.\(^3\)

Few outside shareholders are prepared to battle the entrenched Russian managers. Illiquid markets, informational deficiencies, and insider tenacity have made the Russian corporate sector a minefield not worth entering for most private investors who cannot “vote with their feet” at the first sign of insider dealing.\(^3\) Even some of the largest Russian commercial banks have found asserting control difficult. In one recent skirmish, Uneximbank sought the help of Prime Minister Victor Chernomyrdin to oust the chairman of Norilsk Nickel, a mining company in which Uneximbank had purchased a controlling stake in the loans-for-shares auction of 1996.\(^3\)

Constraints on insider dealing and securities abuses have come from both government legislation and the pressures associated with raising capital. To guard against abuses of so-called “pocket registrars,” the Joint-Stock Company Law provides recourse against both issuer and registrar if deletions of register entries should occur.\(^3\) The 1996 Securities Law likewise provides procedural precautions such as a requirement that companies with more than 500 shareholders use independent share registrars.\(^3\)

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\(^{32}\) See Peter Lee, Taking Stock of Russian Equities, Euromoney, Jan. 10, 1997, at 63, 68 [hereinafter Lee, Russian Equities]. The dilution took place just seven months after another incident in which Surgutneftigaz, following a Presidential edict permitting parent companies to establish 100% control over their units, offered shareholders of one of its refinery units a share swap that significantly diluted their equity value with no compensation for the loss. See Neela Banerjee, Russian Oil Firm’s Share Swap Draws Fire, Wall St. J., Mar. 28, 1996, at A10.

\(^{33}\) See Gray, supra note 21. Gray finds that a weak market squeezes out so-called “passive” shareholders; these shareholders sell their stakes to “discipline managers,” leaving only “active” shareholders behind to vote their shares and exercise control. In Russia, active monitoring and control by large, dynamic shareholders is likely to be the trend for the near term.


\(^{35}\) “Pocket registrar” refers to a registrar who is controlled or influenced by a particular issuer. See Russian Share Registries Come Under Scrutiny, supra note 30.

\(^{36}\) Joint-Stock Company Law, supra note 5.

\(^{37}\) 1996 Securities Law, supra note 1, art. 8(1). In addition, registrars are forbidden to engage in brokering or other operations on the securities market. See Russian Share Registries Come Under Scrutiny, supra note 30.
result, some of the primary investor concerns over the registration of shares, custodial services, and settlement of trades have been allayed to a large extent.\footnote{See Tim Hyam, Reducing Risks in Russia, GLOBAL INVESTOR, Apr. 1996, at 3. The investors' concerns were understandable; in many companies, "physical book entry of the investor's name by company registrars have been the only legal proof of owning shares in the company." Id.}

Legislative reforms provide only a partial explanation for the reduction in managerial malfeasance, nor can Russia rely exclusively on legislation to curtail marketplace abuses. Two additional factors have played a role in checking opportunistic behavior and reducing the risks to investors. First, several Western investment banks have begun offering custodial services by signing contracts with local registrars.\footnote{Id.} These contractual arrangements allow the investment banks to monitor registrars, to require registrars to meet a specified standard of service, and to be held accountable for losses which occur through their fault.\footnote{Id.} In providing custodial services, foreign banks boost investor confidence in the securities market by offering experience and economies of scale which comparable Russian institutions have been previously unable to offer.\footnote{See Lee, Russian Equities, supra note 32, at 64: Large foreign investors have the option of using local brokers, buying shares through them as beneficial owners but allowing the local shares to remain held in the broker's name on the company's share register. That exposes investors to the risk of the broker collapsing. To their intense frustration, many Russian brokers find that, for all their specialist knowledge, they are too thinly capitalized to be acceptable counterparties for institutional investors.}

The change has come about because of enforcement that can best be viewed as reputational. Russian companies now realize that they need large inflows of capital to survive.\footnote{Deputy chairman of the FCSM Alexander Kolesnikov stated: "About 40% of our companies tell us they are ready to reveal any information in order to raise money." Wild East Remains Untamed, supra note 34. The larger Russian companies, such as Rostelecom, are...
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tory marred by stock dilution or registry fraud will harm their ability to raise money in the international capital markets; by contrast, a reputation for integrity and openness is rewarded with foreign investment.44

One result of this sea-change is a kind of race to disclose on the part of the largest Russian companies, despite the tax considerations that keep many companies' financial statements opaque.45 While even these large companies do not provide enough information to qualify for public offerings in the United States, which would require at least three years of GAAP statements and high levels of due diligence, many46 are providing sufficient disclosure to offer Level 1 American Depository Receipts ("ADRs")47 and

said to need billions of dollars each over a number of years. See Lee, Russian Winter, supra note 16, at 52-53.

44 A prime example is the Kominest stock dilution. See supra note 32. In the aftermath, the company apologized and sent its economic team on a "goodwill tour" of London and New York. See Wild East Remains Untamed, supra note 34. It has been estimated that foreign direct investment in Russia will reach U.S. $27 billion between 1996 and 2000, although this number is less than China currently receives in a single year. See Brian Caplen, Fund Managers Betting Big on Russian Prospects, ASIAN BUS., Aug. 1996, at 7-9.


46 Such companies include: Lukoil (Russia's largest vertically integrated oil company); Severskuy Tube Works (a supplier of pipe and casing for Russia's oil and gas companies); Torgovy Dom GUM (the operating company for a large Moscow department store); Tatneft (a Tatarstan oil company); Inkombank (the fifth largest Russian commercial bank); and Chernogomeft (an oil company). At least seven other large banks and firms are in the process of receiving or have already secured SEC approval for ADR issues. See Challenges of Raising Capital, supra note 22.

47 In brief, an ADR is the instrument created when one or more shares purchased by U.S. customers through their brokers from a foreign issuer are held in their original form by a sub-custodian agent of a U.S. depository, and the depository repackages the shares into ADRs for sale to the U.S. customer.

Under Rule 12g3–2(b) of the Securities Exchange Act of 1934, 17 C.F.R § 240.12g3–2(b), Level 1 ADRs are exempt from the otherwise obligatory § 12(g) registration requirements (15 U.S.C. § 78l(g)), provided that the issuer or government official or agency of the country in which it is domiciled and incorporated or organized furnishes to the SEC:

information in each of the following categories the issuer since the beginning of its last fiscal year (A) has made or is required to make public pursuant to the law of the country of its domicile or in which it is incorporated or organized, (B) has filed or is required to file with a stock exchange on which its securities are traded and which was made public by such exchange, or (C) has distributed or is required to distribute to its security holders.

17 C.F.R § 240.12g3–2(b)(1)(i) (1997). The rule further requires the provision of such information during each subsequent fiscal year, when such information becomes available. 17 C.F.R § 240.12g3–2(b)(1)(iii). The SEC has loosely described the information it seeks as:

information material to an investment decision such as: the financial condition or results of operations; changes in business; acquisitions or dispositions of assets; issuance, redemption, or acquisitions of their securities; changes in management or control; the granting of options or the payment of other remuneration to directors or officers; and transactions with directors, officers or principal security holders.
at least one firm has offered Level 3 American Depository Shares through the New York Stock Exchange.\(^4\)

Level 1 ADRs have provided both advantages and drawbacks for Russian issuers. The diminished disclosure requirements allow Russian issuers to gain exposure to global markets and potential foreign direct investment at a lower overall cost of entry.\(^4\) However, because the securities trade over the counter, they suffer from limited liquidity, and issuers need market makers to cultivate investor interest.\(^5\) This complication aside, whatever benefits ADRs offer to Russian companies and sophisticated investors, the larger question is whether the preoccupation with ADRs and international capital markets furthers the development of Russian securities markets and investor participation.

The advancement of Russian capital markets appears to be a marginal consideration in the current rush to offer equity abroad. Domestic issues which might give impetus to the reevaluation and gradual maturation of Russian securities regulation have not, for the present, inspired the spending power or confidence of the general population, despite the allegedly massive savings rate of ordinary Russians.\(^5\) Unlike those of other countries, Russian government debt securities are not popular with individual inves-

17 C.F.R. § 240.12g3–2(b)(3). The words "such as" suggest that the list provides a nonexclusive informational "floor," and that the information required of the issuer by its home government or provided to an exchange at least inquires as to this basic data.

Once the ADR is registered with the SEC, the ADR becomes legally the issuance of the entity deemed to be created by the contract between the foreign company and the U.S. depository bank, rather than of either one of them separately. For a good, clear explanation of the concept behind ADRs/GDRs see Joseph Velli, *American Depository Receipts: An Overview*, 17 *FORDHAM INT'L L.J.* S38 (1994).


\(^4\) See Challenges of Raising Capital, supra note 22.

\(^5\) Id. In addition, many large U.S. institutional investors, such as pension funds, cannot invest in Level 1 securities because of their inadequate disclosure levels.

\(^5\) The Russian State Committee for Statistics ("GOSKOMSTAT") has pegged the cumulative volume of savings for 1995 at 214 trillion rubles, or 22.7% of income. *See Structure of Savings Among the Population, Russ. & COMMONWEALTH BUS. L. REP.*, Sept. 24, 1996, available in LEXIS, World Library, Allwld File. In order of preference, the favorite means of saving among the general population have been: (1) purchase of foreign currency (R135 trillion); (2) bank deposits, two-thirds of which are with the main federal savings bank Sberbank (R46 trillion); and (3) cash in hand (R33 trillion). Id. This figure is disputed by various commentators who question GOSKOMSTAT's method of calculation, and instead calculate the true savings rate to be around 9%. *See Press Conference with Richard Layard, Professor, London School Of Economics, on the Current Economic Situation in Russia, Official Kremlin Int'l News Broadcast*, Mar. 17, 1997, available in LEXIS, World Library, Allwld File.
tors,\(^5^2\) and the principal investment in stocks by the population ended with
the conclusion of voucher privatization in July 1994.\(^5^3\) Ordinary investors
have become exceptionally risk-averse after their savings were wiped out
by the 1992-1993 bouts of hyper-inflation, by the government’s monetary
responses,\(^5^4\) and by the 1994 collapse of the MMM pyramid scheme.\(^5^5\)
These experiences begin to explain the popular apathy toward the more
profitable investment opportunities in Russia. In addition, investors are
rightfully wary of proven managerial hostility toward outside shareholders
and the resulting information inefficiencies that render most corporate secu-
rities highly illiquid. The 1996 Securities Law and collateral regulations is-
sued by the FCSM seem to be aimed at this lack of information and high
degree of risk aversion among the general investor populace.

Despite regulatory initiatives by the FCSM, the largest and financially
most transparent Russian issuers continue to raise capital in the interna-
tional markets.\(^5^6\) The size and illiquidity of the Russian market\(^5^7\) and the
specter of unchecked insider trading\(^5^8\) have not only kept retail domestic in-
vestors away, but have also resulted in capital flight at the rate of U.S. $10
billion a year, with the aggregate estimated amount of offshore funds be-
tween U.S. $40 and $100 billion.\(^5^9\) Even more worrisome is the trend to-

\(^5^2\) This despite the fact that they are the most liquid securities trading on the Russian mar-
ket, with yields running to 70%. See Andrew Burchill, *Is Russia Ready for Mutual Funds?*,
INSTITUTIONAL INVESTOR, Mar. 31, 1996, at 85.

\(^5^3\) *Id.* In the course of voucher privatization, investors could purchase shares with vouch-
ers rather than with cash. The privatization process did not result in widespread ownership
of Russian corporate equity: one study concluded that 19% of Russians working for privat-
ized firms obtained 56% of the equity sold through June 1994, while the 81% of Russians
with vouchers obtained only 15% of the equity. *See* Joseph Blasi, *Russian Privatization:
Ownership, Governance, and Restructuring, in RUSSIA: CREATING PRIVATE ENTERPRISES
note 21.

\(^5^4\) See Caplen, *supra* note 44.

\(^5^5\) For further discussion of the MMM pyramid scheme, see *infra* note 87.

\(^5^6\) At the beginning of 1997, ADRs already accounted for a substantial portion of the out-
standing equity of many well-known Russian companies: 24% of Mosenergo; 20% of Lu-
koi; 17% of Chernogomeft; 15% of Seversky Tube Works; and 21% of VimpelCom. This
contradicts the wisdom that “ADRs should become a less important vehicle for trading in
Russian equity as the local market develops more robust infrastructure, better regulation and
larger domestic investors.” *See* Lee, *Russian Equities, supra* note 32.

\(^5^7\) During the second half of 1996, the top 10 companies trading on the Russian Trading
System (“RTS”) accounted for U.S. $22 billion, or roughly two-thirds, of its total capitaliza-

\(^5^8\) *See* Lee, *Russian Equities, supra* note 32 (“There is almost nothing to prevent insider
trading in Russia. Prices can move dramatically on thin volumes.”).

\(^5^9\) *See* Caplen, *supra* note 44. Another figure, provided by Interpol and Russian Interior
Ministry, suggests that Russians have salted away more than U.S. $300 billion in foreign
banks, most of which left the country illegally and untaxed. *See* Remnick, *supra* note 19, at
37.
ward debt financing; on the heels of a successful Russian government Eurobond issue in November 1996, many Russian companies have begun to consider and execute similar debt issues in the global marketplace, insofar as they would not involve ceding any additional control to foreign outside shareholders and would be easier to justify politically. In response, the chairman of the FCSM, Dmitry Vasilyev, stated: "[W]e should not forget that we should try to lure the market back and that the Eurobonds and the ADRs, American Depositary Receipts, cannot be the mainstream trend of the Russian market. We need the market here and now, in Russia.

Managerial fear of losing control and reticence to disclose is only part of the problem, however. The shape of the market and the incentives of offering equity to foreign investors are rooted in other causes as well, one of which is the deficiency of judicial enforcement of the laws currently in place.

B. Enforcement

Within its emphasis on systematic disclosure, the 1996 Securities Law owes more of its heritage to the U.S. securities laws of the New Deal than to the regulatory regimes of any other country or period. Since before the New Deal, the U.S. philosophy of securities regulation has been based on the provision of continuous, accurate, public disclosure as a rem-
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... and as a way to reduce risk associated with the purchase and sale of securities. Many debates regarding the utility of the U.S. disclosure approach take as a given the presence of adequate enforcement mechanisms as the backdrop to such regulation. Yet, the problem of enforcement was the principal catalyst for the adoption of the 1933 and 1934 Acts. Between 1911 and 1933, forty-seven states and the territory of Hawaii enacted securities regulation statutes, or “blue sky laws.” Such laws proved deficient because their jurisdictional reach was confined to the borders of their respective states, while much of the actionable securities fraud was characteristically multi-state.

Problems of enforcement in Russia have less to do with jurisdictional limitations than with judicial inexperience in resolving commercial disputes. When the U.S. Congress passed the 1933 and 1934 Acts, federal judges possessed abundant experience in deciding matters of contract law as well as issues of fraud, and in resolving disputes between corporations and shareholders. If judges lacked experience in one area of law, they could frequently rely on precedent.

Russian courts provide a stark contrast. Whereas the enforcement of the legal documents for securities issues and sale and purchase agreements requires a solid knowledge of private contract law and training in contractual interpretation, Russian courts often lack such proficiency and training.

Commercial transactions between private parties were only recently legalized after almost seventy years of suppression, and even criminalization, of private trade and commerce. As a result, Russia suffers both from a lack of legal institutions with a credible history of contract enforcement and from the lack of a business culture that could provide a general source for a reputation-based sanctioning system.

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64 See Joel Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. Corp. L. 1, 18–33 (1983) [hereinafter Seligman, Disclosure System].
65 See id. at 52–53:

The assumption that investors will be more willing to purchase securities when compulsory disclosure of material information reduces the incidence of fraud, increases the reliability of estimates of firm value, or reduces the volatility of securities price swings is an articulation of the familiar financial theory of risk aversion. . . . By reducing the perceived risk of corporate securities, compulsory disclosure would tend to reduce the risk premia that issuers selling new securities would have to pay, thus increasing the funds available for economic growth. Reduction of investors' concerns that securities fraud waves periodically may drive down securities price levels will tend to increase propensities to save. And reductions in the volatility of market price swings (caused by investor ignorance of material data) will tend to increase allocative efficiency.
66 Id. at 20.
67 Id. at 21.
Application of the U.S. securities regulation regime, so closely emulated by the Russian drafters of the 1996 Securities Law, has often hinged, in the United States, on judicial interpretation of complex statutory provisions and hair-splitting distinctions on the adequacy — or "materiality"— of misrepresentations or omissions in disclosed information.69 The Russian courts are far from able to attempt such rigorous analysis. The courts that would have direct authority over cases involving entrepreneurs, private organizations, or state organs are the so-called Arbitrazh Courts, or courts of arbitration.70 These courts are lineal descendants of the state arbitrazh system ("Gosarbitrazh") which served as a state-administered tribunal for the resolution of conflicts between state enterprises arising from the implementation of Soviet-era economic plans.71 Despite the change in their purpose and function, the personnel of Gosarbitrazh remains predominantly unchanged in the Arbitrazh courts.72 And as senior judges themselves occasionally admit, they are poorly equipped to resolve modern commercial disputes based on paradigms that were considered heretical when they were studying and beginning to practice law.73

A number of other barriers exist to U.S.-style judicial enforcement of Russian securities laws. First, because Russia is a civil law country, its courts will have difficulty mitigating the effects of poorly drafted or contradictory statutes through a process familiar to common law jurists as "inter-

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70 See Pistor, supra note 68, at 71–73.
72 See Pistor, supra note 68, at 69.
73 See, for example, the statement of the first vice-president of the Supreme Court of Arbitration, Mikhail Yukov: "This share business is too complicated for us. We don't understand it." Elif Kaban, Shares, Guns and Bodyguards in Russia's Courts, REUTERS WORLD SERVICE, May 14, 1995, available in LEXIS, World Library, Allwld File. See also Steve Lieberman, et al., Rethinking an Empire: The New Russia, WALL St. J., June 4, 1996, at A1 ("[Russian] courts can barely enforce a weak constitutional and legal system.")
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Second, the courts, like many other institutions, including the FCSM, lack adequate funds and staff. Third, many Russians view with distrust courts that dispensed justice under Soviet laws prior to 1991. Even if this were not a potential consideration, the problem is compounded by the recognition that many transactions are semi-legal to begin with: contracts drawn up with the most rudimentary provisions are presumed to stand in for a second, more detailed unofficial contract the purpose of which is to evade taxes or conceal certain elements of a transaction that might render the contract legally unenforceable and possibly induce criminal sanctions against the signatories.

Lastly, to dispel the notion that the problem of enforcement is entirely attributable to flawed courts, a substantial part of the enforcement difficulty is due to the nature of statutory drafting in Russia. New laws typically do not explicitly amend or repeal prior laws. Instead, a statute may state that provisions of old laws are ineffective to the extent that they contradict the new statute. If the interpretation of even the clearest of rules must be set

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74 See Shirley Goldstein & Mary Holland, Post-Soviet Economies Forged in Crucible of Legal Change: New Nations Radically Alter Their Regimes, N.Y.L.J., May 20, 1996, at S2. Unfortunately, this is not the only drawback companies face under civil law regimes. In a recent article, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny argue that countries adhering to an English common-law legal regime are significantly more protective of shareholders' and creditors' rights than countries with legal systems based on German or French civil law. In addition, common-law countries are better at enforcing the laws on their books. By consequence, common-law countries enjoy higher-valued stockmarkets (as a percentage of GNP) as well as a larger number of initial public offerings. See Rafael La Porta, et al., 52 Legal Determinants of Corporate Finance 1131 (July 1, 1997), available in 1997 WL 12797147.

In Russia, unlike other civil law countries, the development of legal concepts underlying the capital markets halted soon after the 1917 Revolution. Consequently, as late as 1994, Russian civil law scholars would fall back on Russian civil law concepts prevalent in the first three decades of the twentieth century to define, for example, the property rights implicit in a common share. This flawed foundation is yet another obstacle to the rapid development of securities regulation in Russia. See Andrei A. Baev, Implications of Emerging Legal Structures for Capital Markets in Russia, 2 STAN. J. L. BUS. & FIN. 211, 234-38 & n.97 (1996).

75 See Jonas Bernstein, Murder in Moscow, WALL ST. J., Nov. 7, 1996, at A22. It is unclear to what extent this currently hampstrings Russian Arbitrazh courts: despite being legally bound to decide economic disputes within two months after a claim is filed, see Pistor, supra note 68, at 75, the number of economic disputes at such courts dropped significantly between 1991 and 1994, and does not correlate with an overall decline in production among regions. Id. at 71, 80-81.

76 See Pistor, supra note 68, at 80 ("Parties may hesitate to make use of a system that evokes memories of the past regime.").

77 Id. at 83.

78 See Bauer, supra note 18, at 372. For example, as the new Russian Civil Code was being enacted piecemeal, sections of the 1964 Code remained in effect to the extent that new provisions had not been enacted to replace them. See Lane H. Blumenfeld, Russia's New Civil Code: The Legal Foundation for Russia's Emerging Market Economy, 30 INT'L LAW.
against prior rules to ascertain how much of the old remains a part of the new, the Arbitrazh courts may face a vast legal morass that spawns otherwise unnecessary litigation.\(^7\) Or, the courts may find themselves largely ignored, as they are today.

Administrative enforcement is hardly more effective, though perhaps more for reasons of inadequate resources than for a lack of familiarity with the commercial setting. From the time it was established in November 1994 through the time of this writing, the FCSM has lacked the power to investigate and enforce its regulations on a par with the U.S. Securities Exchange Commission ("SEC").\(^8\) The FCSM hopes to push through amendments to the Civil-Procedural Code that would outline a mechanism for class action lawsuits.\(^9\) In the meantime, the FCSM has urged investors to resolve their complaints through the courts rather than through complaints to government officials,\(^2\) a solution hardly meaningful for defrauded investors, but necessary if a civil enforcement system is ever to take root in Russian.

477, 487 (1996). This vestigial interstitial role for Soviet-era laws is particularly troublesome because civil codes enjoy semiconstitutional status in civil law societies such as Russia. Id. at 487--488. The reconciliation of one Civil Code based on the principles of a command economy and another based on the freedom of contract would baffle any jurist, no matter how experienced.

\(^7\) See id. It is a common argument that the more certainty a law and its accumulated interpretation provide as to the likely outcome in a dispute, the less parties are inclined to expend resources on litigation. Instead, parties will prefer out-of-court settlement. See Pistor, supra note 68, at 64. However, in Russia, contracting parties seem to prefer the uncertainty of private dispute resolution to the unpredictability of a judicial ruling. Such alternative means of arbitration often rely on extralegal and violent methods of enforcement. As one Russian executive noted, "unfortunately, the only lawyer in this country is the Kalashnikov. People mostly solve their problems in this way. In this country there is no respect for the law, no culture of law, no judicial system — it's just being created." Remnick, supra note 19, at 36.

\(^8\) See March 5 Press Conference, supra note 61. Vasilyev noted that the FCSM was working on a draft law that would give it such investigatory powers. He also noted that the 1997 federal budget allocated funds only for the remuneration of FCSM employees, leaving "not a kopeck" for the development of the infrastructure of the stock market. Id. Elsewhere, somewhat cryptically, Vasilyev confessed that "[the] commission will always have less authority than the American one because of the tradition of Russian legislation." See Mileusnic, Boardroom Revolution, supra note 20. The FCSM currently lacks the power to punish company managers and intermediaries for violating investors' rights. Its powers are limited to reprimanding a company that violates such rights, or withdrawing a license from a market participant. See Russia's Securities Commission Wants More Power, REUTERS FIN. SERVICE, Apr. 16, 1997, available in LEXIS, World Library, Allwild File. However, the new Russian Criminal Code now criminalizes securities fraud (in § 185, see infra note 165) and operating on the securities market without a license (in § 171).

\(^9\) See March 5 Press Conference, supra note 61.

\(^2\) See Thornhill, supra note 6.

\(^3\)In effect, Chairman Vasilyev's urgings that investors use the courts to resolve their disputes is an attempt to end a catch-22 situation: until investors make effective use of the
C. Commercial Banks

Arguably, the greatest threats to the FCSM's establishment of a meaningful securities market in Russia are not managerial abuses on the market or the ineffectiveness of various enforcement institutions, but rather the market's potential irrelevance. On the heels of voucher privatization, large Russian commercial banks have engaged in transactions in securities. Their entry has heightened the possibility that, absent a form of Glass-Steagall separation between commercial and investment banking activity, Russia will develop a financing system similar to that in Japan and Continental European countries such as Germany.\(^8\)

The development of the commercial banking sector in Russia should be viewed in tandem with the lackluster growth of native investment funds and brokerage houses.\(^8\) Part of the reason for this lack of investment funds and brokerage houses is attributable to a high degree of risk aversion among Russians. Many remember losing their savings to poorly managed, illiquid voucher funds at the start of privatization, and to the collapse of Sergei Mavrodi's MMM pyramid scheme during the summer of 1994.\(^8\)

\(\text{\footnotesize Notes and Citations}\)

\(\text{\footnotesize 8} \) See Andrew Burchill, \textit{Russia: Mutual Funds -- People's Capitalism Comes to Russia}, \textit{Institutional Investor}, Jan. 31, 1997, at 23. The MMM "mutual fund" was promoted through saturation advertising. With no other statutory tools at hand, the Russian government prosecuted the fund's creator, Sergei Mavrodi, on charges of tax evasion. There the resemblance to the prosecution of Al Capone ends. Mavrodi was exonerated, and thereafter won a seat in the Duma, the lower house of the Russian parliament. \textit{See Wild East Remains Untamed, supra} note 34. With respect to the absence of legal grounds to prosecute MMM, see Mikhail Dubik, \textit{Laws Too Vague to Take on MMM}, \textit{Moscow Times}, July 28, 1994, at 1.
Most Russian banks avoided becoming tainted by such abuses. Beginning in 1990, many secured their capital by reorganizing as joint-stock companies and issuing shares to the public. Many banks, moreover, were formed out of former Soviet ministries, and thus retained significant connections to, as well as input from, government officials. Others were created by formerly state-owned enterprises, and thus had ready corporate clients as "borrowers," some of which are giants in their respective industries even on a global scale.

As Russian securities firms played second fiddle to Western investment funds, Russian banks assembled vast industrial conglomerates into Financial Industrial Groups ("FIGs"), typically structured as a bank hub surrounded by various production, distribution, and retail concerns. One example is the Uneximbank empire, which includes holdings in metal processing, auto making, retail distribution, mining, and other industries. Another, the Rosprom FIG, grouped around Menatep Bank, "owns controlling stakes in more than thirty companies in the construction, food, textile, mining, and chemicals industries." These groupings now compete in many separate sectors of the Russian economy: Most & Stolichny banks in retail banking; Menatep & Uneximbank in the chemical industry; Most and

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88 See Brown, Brokers, Banks, supra note 24, at 209. Both domestically and abroad, the banks were perceived as being subject to heightened regulatory oversight and consequently inspired greater confidence than Russian securities firms, regardless of whether such confidence was warranted.
89 Id. at 207.
90 Id. at 205.
91 For example, Imperial Bank was formed with the assistance of Gazprom, a colossus in the natural gas industry. Likewise, Gossnab, a government agency, assisted Nefteyugansk Oil in the formation of Tokobank. Aeroflot, the Russian state airline company, formed Aeroflotbank. Perhaps the best illustration of the close relationship between corporations and banks is provided by Rossiskiy Kredit, which had as shareholders the Tula Weapons Factory, the Krasnoyarsk Aluminum Factory, the Molniya Research and Production Association, the Priokskiy Non-ferrous Metal Factory, the Kotlass Pulp-and-Paper Combine, the Voskresensk Mashinostroitel Plant, Moscow’s Orbita-Servis Association, and the Novocherkassk Electrode Factory. See id. at 205 & n.113. Such shareholding patterns are typical of Russian Financial Industrial Groups ("FIGs"). See infra text accompanying notes 92–96 & 104–10.
92 See Lee, Russian Equities, supra note 32. As the head of research at one Russian broker put it, "Our job is to discover [viable Russian firms] and bring them to the market. We are the foot soldiers for the big international investment banks." Id.
94 Id.
95 See Liesman et al., supra note 73. The government retains a substantial interest in many of these companies.
Uneximbank in the credit and debit card markets; and virtually all in the oil sector.96

The banks and their investment subsidiaries are accomplishing what Russian stand-alone securities firms and voucher funds have so far failed to do: they are becoming corporate monitors.97 To a large extent, this monitoring is a necessary function in an environment prone to repeated and extensive insider dealing by corporate managers. However, the bank-dominated model also involves an inherent conflict of interest: when commercial lenders both provide short-term credit and act as advisers regarding long-term funding, they are frequently motivated to act in their own best interests rather than the interests of the companies they serve.98 As self-interested entities, banks might prefer loans to equity financing, particularly if new share issues will dilute their stake in a firm.99 As characteristically risk-averse institutions, banks focus intensely on the ability to repay, with collateral and cash flow as primary indicia.100 As fixed claimants, the banks’ risk aversion is enhanced by their conflict with residual claimants (shareholders) who have a greater incentive to maximize the value of the firm through risky projects with large potential upsides.101 In bank-dominated societies such as Japan and Germany, small companies are unable to secure badly needed capital either through bank loans or through the domestic or international capital markets.102 In contrast, large companies have a choice of turning to the international capital markets and listing on

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97 See, for example, Uneximbank’s relationship with Norilsk Nickel, text accompanying note 34. Professor Brown provides a comparable picture:

Overall, [voucher] 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 investments and did not attempt to improve management skills or long-term profitability.


98 See Brown, Brokers, Banks, supra note 24, at 217.

99 Id. at 217 n.198. An example is Menatep Bank’s recent acquisition of a 38% stake in Yukos, Russia’s largest oil company by quantity of reserves. When a recent decree gave Russian companies with substantial debts to the state and wage arrears the right to issue shares to cover such payments, Menatep’s management was not entirely pleased; its vice-president stated: “We will be managing the issue, but it is a shame the money cannot be used more productively, such as for investment in new projects.” See Russia: Russiamoney – Locked Assets, supra note 34.

100 See Brown, Brokers, Banks, supra note 24, at 219.

101 See Jonathan R. Macey & Geoffrey P. Miller, Universal Banks are Not the Answer to America’s Corporate Governance “Problem”: A Look at Germany, Japan, and the U.S., J. APPLIED CORP. FIN., Winter 1997, at 57.

102 See Brown, Brokers, Banks, supra note 24, at 218 & n.204.
foreign exchanges if they do not like the terms offered by domestic lending institutions.\(^{103}\)

Russian bankers and government officials are eager to promulgate the impression that the development of Russian commercial banks into FIGs and the cross-shareholding patterns of major industry players is reminiscent of Japanese *keiretsus*.\(^{104}\) Russia's central bank governor Sergei Dubinin confirmed that "Russia is closer to the continental European model than the Anglo-Saxon one. It is an economy with stable industrial groups and large blocks of shares are controlled by these holdings. This is the real economic situation here."\(^{105}\) The banks are in a better position to wrap their acquisitions in nationalist sentiment: it is more palatable politically to build strong Russian-dominated conglomerates than to see Russian companies fall into the hands of foreign investors.\(^{106}\)

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\(^{103}\) *Id.* at 218.

\(^{104}\) Yuri Milner, CEO of Alliance-Menatep, the Menatep Group's investment banking arm, flatly stated that "Menatep and Unexim [banks] have chosen to develop into Japanese-type organizations." *See Russia: Russiamoney—Locked Assets, supra* note 34.

\(^{105}\) *Id.*

\(^{106}\) George Ermolinkin, executive director of the Russian Association of FIGs, noted: "[Russians] believe in the idea of a powerful Russia and the FIG is the best way to achieve that. Of course it is not transparent, but I would rather give the shares to Menatep Bank than some company I had never heard of." *Id.* Writes Olga Kryshtanovskaya, "The economic interests of the new Russia's business elite determine its basic political values: the idea of strong centralized state, adherence to patriotism, civil peace and accord, support of strong groups or monopolies being the utmost expression of Russia's traditional industrial power." *See Olga Kryshtanovskaya, Financial Oligarchy in Russia, RusData Dialine-BizEkon News, Jan. 10, 1996, available in LEXIS, World Library, Allwld File.*

The controversial "loans-for-shares" transactions in November and December 1995 provided another example of the exclusion of foreigners. The program allowed high-ranking Russian banks the right to hold government stakes in some of the largest blue-chip companies in return for a U.S. $1 billion loan to the government. *See Poul Funder Larsen, State Seeks Loans-for-Shares Deadline Reprieve, MOSCOW TIMES, Aug. 10, 1996, available in LEXIS, World Library, Allwld File.* Although the shares were to be returned if the government repaid the loans, no one seriously expected repayment to occur. *Id.* Under the rules of the loans-for-shares auction, the banks could sell the shares and keep 30% of the capital gains, with the remainder going to the state. *Id.* Alternatively, the banks could keep the shares for a maximum of three years before selling. The program was criticized as a gift for insiders in which a narrow circle of politically connected banks grabbed up prime equities at discount prices. In seven of the auctions, foreign bidders were barred from participating. *Id.* The swift rise in stock market values since the beginning of 1996 and the high proportion of the capital gains which the banks would have to surrender to the state proved an obvious disincentive to the immediate sale of the stakes. *Id.* Unless the initial rules of the loans-for-shares scheme are renegotiated, the state's capital gains "cut" either eliminates the banks' impetus to increase share value, or provides a reason to keep the shares for as long as possible. *Id.*
The acquisitions that the banks made for their FIGs during 1994–1996 are not likely instances of short-term arbitrage. Whatever their long-term motivations, many have chosen to portray the banks as the most effective corporate monitors in an economy rife with fraud and corruption. Thus, one opinion holds:

[T]he groups play a key economic role. With foreign investment at just $1 billion a year, the government in debt, and Russia’s capital markets too illiquid to tap, the groups are channeling capital, technology, and new management into enterprises sorely in need of restructuring. Many observers see the Russian-style zaibatsu as potential engines for spurring an economic revival.

While an economic revival is one foreseeable outcome of the monitoring and restructuring functions that the banks carry out, the larger question is whether the intrinsic conflict of interest between the banks’ monitoring/advisory role and their commercial, self-interested role will stunt a nascent securities market and foreclose a potentially even more vibrant Russian economy. Given the influence that the banks wield in the government, their arguably salutary role with respect to corporate gover-

<table>
<thead>
<tr>
<th>BANK</th>
<th>COMPANY</th>
<th>PERCENTAGE</th>
<th>PRICE (U.S.$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uneximbank</td>
<td>Norilsk Nickel</td>
<td>38%</td>
<td>$170m</td>
</tr>
<tr>
<td>Uneximbank</td>
<td>Sidanko</td>
<td>51%</td>
<td>$130m</td>
</tr>
<tr>
<td>Menatep Bank</td>
<td>Yukos</td>
<td>45%</td>
<td>$150m</td>
</tr>
<tr>
<td>Menatep Bank</td>
<td>Murmansk Shipping</td>
<td>23.5%</td>
<td>$4.1m</td>
</tr>
<tr>
<td>Stolichny Bank</td>
<td>Sibneft</td>
<td>51%</td>
<td>$100.3m (guaranteed by Menatep Bank)</td>
</tr>
<tr>
<td>Imperial Bank</td>
<td>Lukoil</td>
<td>5%</td>
<td>$35m</td>
</tr>
<tr>
<td>Surgut Pension Fund</td>
<td>Surgut</td>
<td>40.1%</td>
<td>$118.5m (guaranteed by Uneximbank)</td>
</tr>
</tbody>
</table>

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The stakes purchased during the first round of the loans-for-shares auction are as follows:

107 Both Menatep Bank and Uneximbank have declared their intention to retain indefinitely the control of the stakes acquired during the first round of the loans-for-shares auction. See Russia: Russiamoney – Locked Assets, supra note 34. For the background of the loans-for-shares auction, see Larsen, supra note 106.


109 Their support comes chiefly from the Ministry of Finance, the Central Bank, and various members of the Presidential cabinet. After the reelection of President Yeltsin in 1996, Boris Berezovsky, head of the LogoVaz group, and Vladimire Potanin, the head of Uneximbank and its affiliated group, were appointed to high posts in the Russian government, the former as Deputy Secretary of the Security Council, the latter as First Deputy Prime Minister. Although Potanin was subsequently sacked, Berezovsky continued to represent the interests of the FIGs in the government until his dismissal on November 5, 1997. See Floriana Fossato, Russia: Media, Money and Power - An Analysis, RADIO FREE EUR./ RADIO LIBERTY,
ernance, and the nationalist appeal of the FIGs, Russia is prone to develop relatively weak capital markets. Whether the configuration of the Russian economy will follow the German or the Japanese model is a matter for speculation, dependent in part on how intrusively the government chooses to regulate the size and manner of capital flows to corporations. Any securities legislation that Russia adopts is sure to influence how quickly the securities market develops and what form it eventually takes. A regulatory paradigm unsuited for the system currently developing in Russia and incognizant of the trends that distinguish it from the U.S. system risks accelerating its own demise.

II. THE DUTY TO DISCLOSE IN THE RUSSIAN 1996 SECURITIES LAW

To what extent does the 1996 Securities Law and its supporting regulations fit the capital market regime currently evolving in Russia? Does it take into account the forces that seek to impede the growth of its securities market, and seek to act against them? Or does it dismiss them? Is a U.S.-style, disclosure-based system warranted given that the absence of adequate enforcing institutions and a high level of noncompliance with existing laws distinguish 1990s Russia from 1930s United States? The remaining sections of this article will reflect on these issues and focus primarily on the duty to provide truthful disclosure, as this duty is the acknowledged staple of both the 1996 Securities Law and the U.S. 1933 and 1934 Acts. While the importance of other provisions such as the prohibition on insider trading and the regulation of professional market participants is undisputed, each of these require a separate discussion. In this article, regulatory attempts at establishing a securities market will be cited to the extent that they


110 *See* Brown, *Brokers, Banks, supra* note 24, at 220–232. Whether or not the government chooses to erect a form of separation between the banking and securities industries might not matter: Japan has been able to circumvent a similar separation imposed by the American Occupation authorities and in effect since the end of the Second World War. *Id.* at 228–30.


112 *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976):

The Securities Act of 1933 ... was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified liabilities, to promote ethical standards of honesty and fair dealing. ... The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.
further or restrain such endeavors and to the extent that they acknowledge
the three areas already mentioned, namely, shareholders' rights, enforce-
ment problems, and bank dominance.113

A. The Utility of the U.S. Model

Underpinning the duty of disclosure imposed on businesses and foreign
government issuers by the 1933 and 1934 Acts was the aim of remedying
information asymmetries.114 Before and during the Senate Pecora hearings
of 1932–1934, investors were shown to have been repeatedly subjected to
abuses ranging from material omissions in proxy statements to insider
trading to dilution of foreign bonds pledged as security under an indenture
agreement.115 From a more procedural perspective, the enhanced remedies
and safeguards provided by the 1933 and 1934 Acts also stemmed from a
recognition that rules against fraud alone were ineffective in restraining
market abuses if firms chose to be silent.116 Absent mandatory disclosure
rules, the cost of obtaining truthful and reasonably complete information
about an issuer of securities would outweigh the benefits of an investment
— unless the intended purchase was of a relatively large or controlling
stake. In contrast, if no one probed for information material to an invest-
ment decision, a potential investor would seek ex ante compensation for the
risk that any undisclosed information, once revealed, would reflect poorly
on the issuer and on the value of the investment ex post.117

Several other justifications are commonly given for mandatory, sys-
tematized disclosure. First, the 1933 and 1934 Acts embody the view that
the issuer is ultimately in the best position to disclose information about it-

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113 See discussion supra Parts I.A.–I.C.
114 Joel Seligman, The Obsolescence of Wall Street: A Contextual Approach to the
[hereinafter Seligman, Obsolescence].
116 See Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protec-
117 See Seligman, Disclosure System, supra note 64, at 53. In fact, the risk of this is
probably greater than 50% because (the investor reasons) if the information added value to
the investment and improved the prospects of the issuer, why would the issuer squelch it? Cf.
Easterbrook & Fischel, supra note 116, at 683 (“If the firm simply asked for money
without disclosing the project and managers involved, . . . it would get nothing. Investors
would assume the worst, because, they would reason that if the firm had anything good to
say for itself it would do so.”). But cases can be imagined where beneficial insider informa-
tion is useful to management in the short term. Alternatively, some information may be held
back because a substantial long-term benefit depends on its present nondisclosure. See, e.g.,
Basic v. Levinson, 485 U.S. 224 (1988) (finding that misleading statements by company
management in respect of confidential merger discussions were only potentially significant
to plaintiffs’ investment decision due to the high probability that such discussions would
collapse).
self at the least cost both to itself and potential investors.\textsuperscript{118} Second, a
uniform duty of disclosure solves a persistent collective action problem in
which firms acting individually would hesitate to disclose information useful
to their competitors unless such competitors were also disclosing the
same type of information.\textsuperscript{119} Third, because a mandatory disclosure regime
lowers overall investment costs, it increases the liquidity of securities.\textsuperscript{120}
This last factor not only increases the profitability of market participants
such as stock exchanges and brokers, but also assures investors the ability
to sell their securities at a moment's notice, and hence greatly diminishes
the risk of "going down with the ship." Finally, a systematized form of dis-
closure enables the comparison of many firms on the basis of related cate-
gories of information.\textsuperscript{121} In addition to reducing the cost of making such
disclosures, this standardized format lowers enforcement costs, both ad-
ministrative, prior to registration, and judicial, during litigation.

Beyond these largely "in hindsight" rationalizations, it is clear that one
of the principal motivating forces behind the final shape of the 1933 Act
was the protection of the small, individual investors\textsuperscript{122} rather than sophisti-
cated investors who could "fend for themselves."\textsuperscript{123} As professed by FCSM
Chairman Vasilyev, the same concern for the proverbial "widows and or-
phans" is at the center of his Commission's efforts to impose and enforce
rigorous disclosure rules on Russian firms.\textsuperscript{124} It is useful to recall, however,
that while U.S. disclosure rules have succeeded in attracting an increasing
number of individual investors since the 1930s,\textsuperscript{125} modern theories on the
structure of securities markets question the capacity of individual investors
to benefit from the disclosed information and the utility of preferring man-

\textsuperscript{118}This is related to the above argument that the issuer has an incentive to minimize a
potential investor's cost of searching out information. See Easterbrook & Fischel, \textit{supra
note 116}, at 685.

\textsuperscript{119}Id. at 685–86.

\textsuperscript{120}Id. at 689–90.

\textsuperscript{121}Id. at 700–01.

\textsuperscript{122}See Seligman, \textit{Obsolescence, supra} note 114, at 659 & n.55 (citing for the same
proposition James Landis, one of the drafters of the Securities Act of 1933).

\textsuperscript{123}See S.E.C. v. Ralston Purina, 346 U.S. 119, 125 (1953).

\textsuperscript{124}See \textit{July 5 Press Conference, supra} note 62:

The concept that was approved by the President orients us at the creation of a powerful
Russian national market of securities. A big accent is being made on the social compo-
nent, on the social orientation of the development of this market in the interests of small
investors, in the interests of citizens.

\textit{See also March 5 Press Conference, supra} note 61:

Of all the laws I would single out one on which progress has been very unsatisfactory.
This is the law on protection of the rights of citizens in the securities market. . . . The
law is of pivotal importance in the light of the current political events because it gives
precedence to the rights of the investor. The individual is always right, and the Com-
mision, the professional participants in the market, or the issuer are wrong.

\textsuperscript{125}See Seligman, \textit{Obsolescence, supra} note 114, at 660.
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datory disclosure to the investigatory and monitoring function performed by professional market participants. Most recently, the SEC's historic insistence on the admittedly burdensome disclosure requirements of the 1933 Act has yielded to a recognition that the efficient market hypothesis, the advent of foreign capital markets as viable alternatives to the domestic market, and the growing influence of institutional investors no longer support to the same extent the traditionally predominant concern with the individual investor.

It is abundantly clear from the discussion above that Russia today lacks the kind of efficient market in which abundant information is instantly parsed by professional market participants and reflected in stock prices. However, this deficiency does not necessarily justify the conclusion that in the absence of an efficient market, the FCSM should rush to protect individual investors through a regulatory regime evocative of the 1933 Act.

126 As Easterbrook & Fischel argue, "[n]o matter what the disclosure laws say, the 'average investor' who gets disclosure statements through the mail will always be too late to take advantage of any bargains available to those who use information first." See supra note 116, at 694.

127 See Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549 (1984). Market "efficiency" is based on the notion that market prices generally reflect available information and that such prices rapidly adjust to new information, diminishing the potential for opportunistic trades (except in the very short term). Id. at 552.

128 See Seligman, Obsolescence, supra note 114, at 682-83.

129 See discussion supra Part I.A. For confirmation that even the largest Russian companies disclose material information to select investment companies and insiders up to one week before making general disclosure to the markets, see Gregory L. White, Lukoil's Unofficial Release of Earnings Highlights Bugs in the Russian Market, WALL ST. J., Dec. 20, 1996, available in Westlaw, 1996 WL 11810430. Although the problem is arguably the result of inefficiency rather than deliberate action, it is plainly endemic.

130 The fact that the FCSM has in fact borrowed extensively from U.S. law is not surprising. A Memorandum of Understanding between the U.S. SEC and the FCSM, signed on December 5 and 6, 1995 by, respectively, Chairman Levitt of the SEC and Chairman Chubais of the FCSM, provides for extensive cooperation between the two regulatory organizations. Item 5 of the Memorandum is telling:

The [SEC and FCSM] anticipate that, subject to the availability of resources, specific assistance may be provided in the following manner:

(a) Assistance by the SEC staff in drafting laws and regulations governing the securities markets, which will include consideration of and reference to the corresponding U.S. securities laws and regulations;

(b) Advisory missions by the SEC staff and other relevant U.S. experts to Russia to conduct intensive training in specific subject areas;

(c) Conducting seminars in the United States and/or Russia concerning securities regulation;

(d) Internship programs for the FCSM personnel at the SEC and for Russian securities market professionals with U.S. financial services providers.

Memorandum of Understanding Between the United States Securities and Exchange Commission and the Federal Commission on Securities and the Capital Market of the Gov-
Other approaches to securities regulation may be much more apt when a tradition of secretive extra-legal transactions, poor enforcement of existing laws, managerial wrongdoing, and oligopolistic industrial groups threaten the development of a market in securities based on ease of entry. A discussion of the merits of such approaches will follow the overview of the disclosure provisions in the 1996 Securities Law.

B. Disclosure Russian-style


The 1996 Securities Law envisions the disclosure of information to potential investors in three contexts: (i) a public offering of securities; (ii) a quarterly report on the securities; and (iii) the occurrence of “essential events and acts bearing on the issuer’s economic and financial activity” of such securities. All issues of securities are subject to registration. A public issue, defined as (i) the distribution of securities to an unlimited number of investors, (ii) the distribution of securities to more than 500 known investors, or (iii) having an aggregate value of more than 50,000 minimum wages (approximately U.S. $750,000 in mid-1996), also requires the registration of a prospectus. Unlike the 1933 Act, the 1996 Securities Law does not command the distribution of a prospectus to potential investors in a public offering. The SEC responded to the duplicative disclosure requirements in the 1933 and 1934 Acts by adopting its integrated disclosure system. See Securities Act Release No. 6235 (Sept. 2, 1980), 20 SEC Dock. 1175; Securities Act Release No. 6383 (Mar. 3, 1982), 24 SEC Dock. 1262. The larger issue is why Russia made the same mistake 60 years later. A likely explanation is that the FCSM would have been ignored were it to attempt to regulate companies directly; as a result, the adoption of the dual disclosure tracks was a calculated decision rather than mere imitation. See Telephone Interview with Bernard Black, Professor of Law at Columbia University School of Law (Apr. 17, 1997).

1996 Securities Law, supra note 1, art. 23.

Id. art. 30.

Id. Article 23 of the 1996 Securities Law contains a further requirement to report information concerning material facts bearing on the financial and economic activities of the issuer. Such facts, events, and activities must be reported to the registering agency within five working days of their occurrence. Id. art. 23.

Id. art. 19.

Id. This quantitative rule resembles the requirements of Rule 502(b) of the 1933 Act, 17 C.F.R. § 230.502(b), in which the quantity and detail of the information to be provided outside of a Section 5 public offering is a function of the aggregate value of the offering. The 1933 Act contains a more graduated spectrum of disclosure requirements than does the Russian Securities Law.
tial investors but seeks to ensure that all investors can obtain access to the information disclosed in the prospectus.\textsuperscript{137} In addition, the 1996 Securities Law requires the registration of an account of the final result of the issue (\textit{otchet ob itogakh vypuska}).\textsuperscript{138}

In view of the scope of disclosure envisioned by the prospectus requirements, the 1996 Securities Law provides abundant opportunities for potentially actionable misrepresentations. The 1996 Securities Law combines disclosure requirements comparable to those contained in the 1933 Act on the public placement of securities\textsuperscript{139} and in the 1934 Act on the information to be disclosed during secondary trading of securities.\textsuperscript{140} Initially, the 1996 Securities Law provisions relating to the post-distribution and secondary trading phase appeared to be more comprehensive than its regulations on registration and prospectus requirements. With the adoption of Decree No. 19,\textsuperscript{141} however, the regulations on the publication of the prospectus\textsuperscript{142} and financial statements\textsuperscript{143} have been vastly expanded, so that they increasingly resemble comparable U.S. regulations under the 1933 Act.\textsuperscript{144}

The prospectus guidelines in Decree No. 19 list more than fifty items that serve as guidelines for disclosure, ranging from broad categories to terse phrases that must be included verbatim on the title page of the pro-

\textsuperscript{137}Id. art. 23. The issuer must publish information about the procedure of accessing the information in a periodical with a circulation of at least 50,000 copies. Id.

\textsuperscript{138}Id. arts. 19, 25. The account of the results of an issue must be submitted to the registering agency within 30 days following the conclusion of the distribution. Id. art. 25.

\textsuperscript{139}See 1996 Securities Law, supra note 1, arts. 19–27.

\textsuperscript{140}See id. art. 30.


\textsuperscript{142}Id., Addendum 3.

\textsuperscript{143}Id., Addendum 4.

\textsuperscript{144}Cf. Regulation S–K under the 1933 Act, 17 C.F.R. § 229.
spectus. Beyond detailed data on the issuer’s managers and directors, the 1996 Securities Law requires disclosure of information with respect to “participants” in the issuer, its membership in any “industrial, banking, and financial groups, holdings, concerns, and associations,” and its function in such organizations, extensive information with respect to the issuer’s primary activities, and comprehensive financial statements for the past three years.

One disclosure item that may prove extremely subjective without clarification and some kind of safe harbor against incorrect predictions relates to “soft” information, including plans of future activities, sources of income, new forms of production, and the expansion or contraction of current production areas. Finally, in addition to the express disclosure provisions listed in the 1996 Securities Law and Decree No. 19, the issuer is instructed to provide “other [material] information which may affect a decision to purchase the issuer’s securities” as well as an analysis of risk factors.

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145 For example, Decree No. 19, supra note 141, Addendum 3, Item 6 requires the inclusion of the phrase “The registering agency is not responsible for the veracity of the information contained in this prospectus, and its registration of such prospectus is not an indication of such agency’s opinion as to the issued securities.” The phrase must be printed in the largest of the typefaces used to print other text on the title page of the prospectus. Cf. Regulation S-K, 17 C.F.R. § 229.501(b)(5): see infra note 165.

146 Such data must include, for example, the issuer’s managerial structure, information about members of its board of directors and officers (as well as all posts held by such directors and officers during the past five years and their holdings in the issuer, if any), as well as the compensation of such officers and directors. See Decree No. 19, supra note 141, Addendum 3, Items 19–22.

147 1996 Securities Law, supra note 1, art. 22. Participants [Uchastniki] are defined as holders of five percent or more of the issuer’s equity, as well as the entities in which the issuer holds an equity stake larger than five percent. See Decree No. 19, supra note 141, Addendum 3, Item 17. Decree No. 19 in turn qualifies this provision by requiring disclosure of the identity, address, and size of stake of any such participants, as well as information on the holders of a 25% or greater stake in the equity or voting stock of such affiliate. See also Items 23, 24, and 26, id. Cf. § 14(d)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(d)(1), which imposes a similar disclosure duty under § 13(d) of the Act on persons who, as a result of a tender offer, directly or indirectly, would become beneficial owners of more than five percent of a class of shares registered under § 12 of the Act.

148 Decree No. 19, supra note 141, Addendum 3, Item 27.

149 The level of detail required is somewhat ameliorated by the statement that such disclosure need not compel the release of information that might adversely affect the issuer’s ability to compete. See id., Addendum 3, Item 28.

150 See id., Addendum 3, Items 32–36. Additionally, financial statements for the issuer’s last fiscal year require an auditor’s opinion and balance sheet data for the last quarter preceding the decision to issue securities. See id. Items 32–36.

151 See id., Addendum 3, Item 28.

152 See id., Addendum 3, Item 31.

153 Risk factors are to be grouped under economic, social, technological, and ecological categories. Id., Addendum 3, Item 49.
As shown above, the FCSM has adopted a disclosure system that requires an issuer to release copious amounts of information about itself, its related organizations, its managerial and directorial staffs, and its financial situation. Despite the amount of information sought, many of the disclosure provisions of the 1996 Securities Act and related FCSM directives are broad and open-ended enough to be burdensome without necessarily leading to disclosure of facts meaningful to the average investor. The magnitude of the burden on Russian companies to comply with such securities legislation is roughly comparable to the burden on the FCSM and the Russian judiciary system to enforce such provisions. It is unclear whether litigation under as-yet unenacted federal legislation allowing for private rights of action under the 1996 Securities Law will give meaning to the disclosure provisions similar to the way in which private suits have done so in the United States. If individual and many sophisticated investors choose to stay away from the courts, as they mainly do today, it is difficult to imagine how the FCSM alone will be able to police and give meaning to its own regulations.

2. Enforcement

Upon receiving all the necessary registration materials and prospectus from the issuer, the registering agency must register the issue within thirty days, or make a "reasoned decision on the denial of registration." The registering agency may deny registration on several grounds, among them the presence of false or "untruthful" information (information not in accordance with reality) in the prospectus or in the decision to issue securities. A particularly troubling provision of the 1996 Securities Law enti-

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154 Disclosure provisions and prospectus requirements applicable upon the issue or conversion of debt or equity following a reorganization, merger, or consolidation of joint-stock companies are covered separately in FCSM Decree No. 8, see supra note 141.

155 One notable exception is the recent victory of a group of foreign and domestic investors in securing representation on the board of the Novolipetsk Metal Company. The group, which owned a combined stake of 40% in the company and sought commensurate representation on the board of directors, won the right to nominate its representatives before a lower Arbitrazh court. The case — actually a combination of three actions — was seen as a crucial test of the ability of outside shareholders to influence the governing process of Russian companies. See John Thornhill, Russian Court Backs Investors: Victory for Shareholders' Rights in Dispute with NLMK, FIN. TIMES, May 22, 1997, at 2.

156 The registering organ would presumably be the FCSM or one of its regional branches. However, the FCSM may delegate this function to other bodies. Prior to the passage of the 1996 Securities Law, this function was exercised by the Ministry of Finance. See Peter J. Pettibone, Russia's New Law on the Securities Market, WORLD SEC. L. REP., July 1996, at 30, 31.

157 1996 Securities Law, supra note 1, art. 20; Decree No. 19, supra note 141, art. 55.

158 1996 Securities Law, supra note 1, art. 21. Other grounds for denial include: (i) the issuer's breach of the requirements of Russian Federation ("RF") legislation on securities, including filed information "warranting the conclusion that the terms and conditions of the
ties the registering agency to halt or invalidate an issue and rescind the pro-
ceeds to the purchasers if the issuer (i) violates Russian law in the course of
an issuance, or (ii) provides untruthful information in the documents on the
basis of which the securities were registered.\textsuperscript{159} The provision enacts a dra-
conian penalty for misstatements which ostensibly need not be material and
which are not subject to any statute of limitations.\textsuperscript{160}

issue and trading of issued securities contradict RF legislation, and concerning a discrepancy
between the terms and conditions of the securities issue and RF legislation on securities; and
(ii) a discrepancy between the filed documents and the information they contain, and re-
quirements of the present Federal Act." \textit{Id.}

Decree No. 19 underscores the drafting inconsistencies in Russian securities legislation
and the difficulties foreseeable in the ultimate interpretation of such legislation. Article 59
of the Decree lists the \textit{exclusive} reasons for a denial of registration of a securities issue as
follows:

(a) A discrepancy between the submitted [registration] documents and the requirements
of legislation, legal enactments, the present Standards, and other enactments of the Fed-
eral Commission;

(b) The presence in the submitted documents of facts warranting the conclusion that the
issuer has violated the terms of legislation, legal acts, the present Standards, and other
acts of the Federal Commission (including their possible violation as a consequence of
the distribution of securities);

(c) The failure to pay in full taxes on securities transactions, as stated in legislation;

(d) The presence in the submitted documents of deliberately false information, as well
as statements prone to mislead [\textit{sposobnykh vvesti v zabluzhdenije}].

Decree No. 19, \textit{supra} note 141, art. 59.

Because the language used in the decree is substantially different from the language used
in Article 20 of the 1996 Securities Law, it is unclear whether and to what extent Decree No.
19 serves to amend, expand, or nullify the 1996 Securities Law provision, or whether it can
be seen to contradict the earlier Law. In the latter case, the provisions of the Decree and the
Law require essential interpretation and reconciliation.

\textsuperscript{159}1996 Securities Law, \textit{supra} note 1, art. 26. It is unclear whether an omission — rather
than an untruthful statement — would qualify as a violation of the 1996 Securities Law dis-
losure provisions. The "statements prone to mislead" language in Decree No. 19, art. 59(d)
might be viewed as reaching omissions, but need official interpretation. The Decree sug-
gests further that the registering agency might be held accountable for omissions [\textit{polnotu
svedenij}] in the prospectus. \textit{See infra} text accompanying note 166. An equally significant
problem is that Article 59 does not mention materiality as a threshold for the denial of regis-
tration.

\textsuperscript{160}\textbf{See} Pettibone, \textit{supra} note 156, at 31. One possible mollifying interpretation of Article
26 would view its language in the context of a similar provision in Presidential Decree No.
1233, \textit{O Zaschite Interesov Investorov} [On the Protection of Investors' Interests], art. 9, June
11, 1994, which gave the registering agency a similar power for "deliberately [\textit{zavedomo}]
false" information. Because Article 26 is entitled "Bad Faith [\textit{Nedobrosovestnaya}] Issu-
ance," it is possible that scienter will be required before nullification and rescission are de-
clared. \textit{See} James Christiansen, \textit{New Russian Securities Law Bolsters Regulator's Powers,
Int'l Fin. L. Rev.}, Aug. 1996, at 29, 30 (1996). Article 59(d) of Decree No. 19 also refers
to deliberately [\textit{zavedomo}] false facts as grounds for denial of registration, \textit{see supra} note 158.

As one critic of the 1996 Securities Law summed up, Article 26 taken literally hangs a
permanent "sword of Damocles" over every issue. \textit{See} Christiansen, \textit{supra}. However, a de-
Once an issue is registered (the “post-effective” period), the issuer has up to one year to complete the distribution of the securities. During such time, the registering agency may demand that the issuer make corrections to untruthful information contained in the prospectus only when such a misstatement is not of material significance or is a technical error. The issuer also has a duty to correct disclosure when any subsequent facts or events may affect an investor’s decision to purchase securities. However, the decision to issue securities and the issue prospectus itself may not be amended during the post-effective period; such documents may only be amended with respect to the terms and conditions of the distribution of securities, and then exclusively if necessary to safeguard the interests of the actual or potential owners of such securities. The resulting rigidity is a strong incentive to get the disclosure right the first time, or face the possibility of issue nullification under Article 26 of the 1996 Securities Law.

Oddly, the enforcement of some disclosure regulations imposes a significant onus on the FCSM (or any other registering agency that has the responsibility for registering a given issue) beyond anything that the SEC must endure. According to Article 54 of Decree No. 19, the registering agency bears responsibility for the adequacy of the information contained in the issue prospectus, but not for its truthfulness. How broadly this decision to nullify an issue is discretionary and may be replaced by a decision to halt the distribution of securities until the misrepresentations are corrected. Moreover, Article 51(3) of the 1996 Securities Law declares that the process of issue nullification under Article 26 must begin with an action filed by the FCSM with a court if the bad faith issue “resulted in a materially significant delusion of the owners [of the securities involved], or if the purposes of the issue are contrary to the principles of law and order and morality.” See infra text accompanying note 203. Thus it seems that a decision on issue nullification is ultimately a judicial, rather than an administrative one.

1996 Securities Law, supra note 1, art. 24. For further discussion of this provision, see text accompanying notes 206-09.

Decree No. 19, supra note 141, art. 65.

The Russian Criminal Code, UK RF § 185 (1997), reinforces this incentive by ordering fines and imprisonment for persons introducing deliberately unreliable [zavedomo nedostovernoj] information into an issue prospectus, confirming a prospectus containing such information, or confirming a deliberately unreliable account of the result of an issue. To trigger such penalties, an offense must have caused a “material loss” [krupnyj ushcherb]. Russian Criminal Code, UK RF § 185 (1997).

Cf. 15 U.S.C. § 77w (1994), which states, in part:

Neither the fact that the registration statement for a security has been filed or is in effect nor the fact that a stop order is not in effect with respect thereto shall be deemed a finding by the Commission that the registration statement is true and accurate on its face or that it does not contain an untrue statement of fact or omit to state a material fact, or be held to mean that the commission has in any way passed upon the merits of, or given approval to, such security.
The enforcement obligations of the FCSM thus clearly approach, and at times surpass, comparable duties of the SEC. In addition to the review of registration documents, the duties of the FCSM include, but are not limited to: i) policing the disclosure made by any owner of the issuer’s securities when such owner’s stake exceeds twenty percent or more of such securities and when such owner’s stake increases or decreases by five percent while remaining above the twenty percent threshold; ii) preventing insider trading; iii) stopping gun-jumping and market conditioning through false, inaccurate, or anticompetitive media advertisements; and iv) licensing professional market participants. Although the primary focus of this article is on disclosure rules and their enforcement by the FCSM, the extent of the FCSM’s other duties are indicative of the formidable task it faces in establishing a securities market adequately safe for the individual Russian investor. In view of the challenges reviewed in Parts I.A–I.C, this article proceeds to question whether a more minimalist approach to securities regulation may be a better alternative for the immediate future.

III. TOWARD A SELF-ENFORCING MODEL OF SECURITIES REGULATION

A. The Problem

In many countries, and especially in the United States, the boundary between corporate and securities law is often vaguely defined; sometimes it vanishes entirely as corporate and securities law provisions complement each other. Proxy rules governing the solicitation of shareholder votes under the Delaware General Corporation Law, for example, are also the

(Emphasis added); in Regulation S–K, 17 C.F.R. § 229.501(b)(5), the required legend on the outside front cover page of a prospectus provides, “THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS.”

For instance, one particularly harsh provision, surpassing even the possibility of nullification under Article 26 of the 1996 Securities Law, is Article 5-19 of Presidential Decree No. 1009, O Federal’noj Komissii Po Rynku Tsennykh Bumag [“On the Federal Commission for the Securities Markets”], July 1, 1996. It gives the FCSM the right to petition the Arbitrazh courts for the liquidation of an entity that breaches the requirements of Russian federal legislation on securities.

1996 Securities Law, supra note 1, art. 30.
Id. arts. 31–33.
Id. arts. 34–36.
Id. art. 39.
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subject of § 14(a) of the 1934 Act, which prohibits the solicitation of, or permission of, the use of any person's name to solicit "any proxy or consent or authorization in respect of any security . . . registered pursuant to section 12" of such Act in contravention of applicable SEC rules and regulations. Likewise, many provisions of the Joint-Stock Company Law reference the 1996 Securities Law or may be designated securities laws themselves.

Consequently, when two laws regulate the same basic terrain — the ability of firms and other legal entities to raise capital — one would expect such laws to have at their base a comparable regulatory and enforcement model, concordant with the legal culture and economic considerations indigenous to the place of enactment. The 1996 Securities Law and related FCSM regulations decidedly are constructed on the principles of a Western regulatory system which stresses a high level of disclosure, enforcement, and policing by courts, administrative bodies, self-regulatory entities such as stock exchanges, and private investors. By contrast, the Joint-Stock

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174 Because the 1996 Securities Law had not been enacted when the Joint-Stock Company Law came into effect, the references are made to "legal acts of the Russian Federation on securities." One example of the overlap between the two laws is found in the Joint-Stock Company Law provision on "Bonds and Other Securities" in Article 33, and in Article 17 of Decree No. 19 (Reference to Article 17 is to the Russian version of Decree No. 19; Article 17 is Article 19 in the Westlaw version.).

Article 33(2) of the Joint-Stock Company Law states that "bonds and other securities shall be placed by a company by decision of the board of directors (supervisory council) of the company, unless otherwise provided for by the company charter." Joint-Stock Company Law, supra note 5. Likewise, Article 17 of Decree No. 19 provides that "a decision as to the issuance of shares or bonds shall be ratified by the board of directors of such joint-stock company [or] the organ which executes the duties of a board of directors in accordance with the laws and other legal acts of the Russian Federation." Decree No. 19, supra note 141.

175 See, for example, the anti-dilution provision of the Joint-Stock Company Law, supra note 141, Article 33, Item 4, which prohibits the placement of bonds and other securities convertible into company stock if the number of a company's outstanding shares of various classes is less than the number of shares of the same classes which such bonds and securities give the right to buy.

176 I hesitate to suggest that a "Western" regulatory framework has influenced the 1996 Securities Law, supra note 1, in part because there is no uniform approach to securities regulation among developed nations. For instance, while U.S. disclosure provisions are meticulously set forth in Regulation S–K, 17 C.F.R. § 229 (1997), England and Canada have shied away from specific disclosure guidelines; both countries favor general instructions (e.g., describe the issuer's business) without providing further guidance as to the specific facts that may be material to an understanding of the issuer's business. See Facilitation of Multinational Securities Offerings, Securities Act Release No. 33-6568, 32 SEC Docket (CCH) 707, 710 (Feb. 28, 1985). On the other hand, 1994 saw the enactment of Germany's Securities Trading Act, Wertpapierhandelsgesetz, BGBI. I 1994, 1749 [hereinafter German Securities Act], which increases the level of issuer disclosure to levels comparable with the 1996 Securities Law. See Hartmut Krause, The German Securities Trading Act (1994): A Ban on Insider Trading and an Issuer's Affirmative Duty to Disclose Material Nonpublic Information, 30 INT'L LAW 555 (1996).
Company Law is grounded in a self-enforcing approach to corporate law promoted by Professors Black and Kraakman in their recent article.\textsuperscript{177} The self-enforcing model may be seen as a best-approach-under-the-circumstances, when the “circumstances” involve the lack of some or all of the institutions commonly found in developed market economies. These include:

- a competitive product market, a reasonably efficient capital market, an active market for corporate control, incentive compensation for managers, and at least occasional oversight by large outside shareholders . . .
- Sophisticated professional accountants, elaborate financial disclosure, an active financial press, and strict antifraud provisions . . . Sophisticated courts . . . administrative agencies . . . and self-regulatory organizations.\textsuperscript{178}

Paradoxically, Black and Kraakman note, emerging economies need the protections of well-defined rules of corporate behavior precisely when institutions and resources capable of policing such behavior are either defective or missing.\textsuperscript{179} Moreover, their absence does not imply that a vacuum exists in their place. On the contrary, various other entities step into the void: FIGs and domestic commercial banks as corporate monitors,\textsuperscript{180} extralegal dispute arbitration occasionally employing violent enforcement methods;\textsuperscript{181} and government officials eager to peddle their influence.\textsuperscript{182}

Faced with a similar lack of effective institutions, the United States and England developed a body of corporate law within what Black and Kraakman term a “prohibitive model.”\textsuperscript{183} Over time, prohibitive codes, which barred outright certain types of corporate conduct most open to abuse, were replaced with “enabling codes” that fashioned default rules, leaving specific instances of abuse to by-now developed institutions.\textsuperscript{184} In selecting among various principles of corporate law for Russia, Black and Kraakman found that whereas the enabling model would provide little if any guidance to

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\textsuperscript{177} See Black & Kraakman, supra note 13.

\textsuperscript{178} Id. at 1920–21. The prospects for an independent financial press have been clouded by the recent interest of large banks and industrial groups in Russian news media. Once acquired, periodicals have served their largest shareholders as vehicles for self-promotion. See Mark Whitehouse, The Money Behind the News, MOSCOW TIMES, Apr. 1, 1997, available in LEXIS, World Library, Allwld File.

\textsuperscript{179} See Black & Kraakman, supra note 13, at 1921.

\textsuperscript{180} See supra text accompanying notes 104–06.

\textsuperscript{181} See, e.g., Bernstein, supra note 75 (describing the assassination of Paul Tatem, an American businessman who became involved in a prolonged dispute over ownership rights in a Moscow hotel complex).

\textsuperscript{182} See Remnick, supra note 19, at 36 (“[B]ribery greases the wheels of commerce. Government officials, who issue licenses and permissions of all sorts, ‘practically have a price list hanging on the office wall.’”).

\textsuperscript{183} Black & Kraakman, supra note 13, at 1930.

\textsuperscript{184} Id. at 1974.
Russian courts, investors, and managers, the prohibitive model was only slightly superior. The enabling model was inappropriate due to the vagueness of its rules and its emphasis on flexibility more suitable to a universe where market participants operated within a fairly well-defined and acknowledged set of enforceable legal and professional boundaries. The prohibitive model failed by virtue of its rigidity, the ease with which it may be avoided over time, and its heavy reliance on judicial or administrative enforcement.\(^{185}\)

It is possible to see the U.S. — and by extension, the Russian — securities regulatory regimes as “prohibitive” in many ways. Numerous provisions of the 1933 and 1934 Acts, as well as the 1996 Securities Law, specifically forbid certain types of conduct with respect to the sale, purchase, promotion, advertisement, or solicitation of securities.\(^{186}\) Both regimes impose highly intrusive and detailed disclosure rules on securities issuers,\(^{187}\) and both employ punitive sanctions against violators of such rules and legislation.\(^{188}\) Yet, the rigid, intrusive, and enforcement-intensive character of this regulatory model is, if anything, self-defeating in the Russian context for the same reason that a prohibitive corporate law would be. By the same token, simple fraud laws are even less likely to halt securities abuses in Russia than they were in the United States prior to 1933, and meager institutional support exists for default rules of operation such as the Delaware General Corporation Law.

The gist of the third alternative — the self-enforcing model — in the corporate law context is the creation of a system of “mandatory procedural and structural rules [that] empower outside directors and large minority shareholders to protect themselves against opportunism by insiders” while minimizing overall reliance on judicial and administrative enforcement.\(^{189}\)

\(^{185}\) Id. at 1931.

\(^{186}\) For example, both the U.S. and Russian regimes restrict certain types of advertisements prior to the registration effective date: 15 U.S.C. § 77e(b)(1), 17 C.F.R. § 230.134, and 1996 Securities Law, supra note 1, art. 36; both regimes restrict offers to sell and offers to buy prior to the filing of the registration documents with the registering agency: 15 U.S.C. § 77e(c) and Decree No. 19, supra note 141, art. 36; and both regimes limit transactions with securities during the waiting period to agreements between the issuer and its underwriter syndicate, 15 U.S.C. §§ 77e(c), 77b(2)(3) and Decree No. 19, supra note 141, art. 36.

\(^{187}\) See Securities Act of 1933, Regulation S–K; Decree No. 19, supra note 141, Addendum 3 (1996); and Decree No. 8, supra note 141, Addendum 3 (1997). In addition, both the U.S. and Russian laws require periodic disclosure filings with their respective securities commissions.

\(^{188}\) In the U.S. context, compare 15 U.S.C. §§ 77q (Fraudulent, Interstate Transactions), 77x (Penalties), 15 U.S.C. §§ 78u(d)(1) (Injunctions), 78u–3 (Cease-and-Desist Proceedings), and 78ff (Penalties), with (in the Russian context) the 1996 Securities Law, supra note 1, art. 51 (1996) (Liability for Breach of RF Legislation on Securities) and Russian Criminal code, UK RF, see note 165, § 185 (1997).

\(^{189}\) See Black & Kraakman, supra note 13, at 1932.
The chief emphasis of this model is on structural constraints (such as shareholder voting requirements triggered by specific corporate actions), simple, bright-line rules, and strong remedies against violations.\textsuperscript{190}

Even so, the term "self-enforcing," as used throughout this discussion should be invoked as a strictly nominal reference to the Black and Kraakman model. It would be a mistake to assume that the structure I propose is \textit{literally} self-enforcing. To emphasize clear rules, reputational constraints, and substitute structures that facilitate the enforcement of the Russian securities laws is not to claim that such laws are enforceable \textit{in and of themselves}. The emphasis of the Black and Kraakman model is rather on the substitution of alternative means of enforcement for the traditional institutions that are either missing or inadequate. Thus, it is only in this narrow sense that the rubric "self-enforcement" is used herein.

The aim now is to see whether the enabling model applied in the Russian corporate context can be transplanted successfully to its securities regulatory framework.

\section*{B. The Relevance of the Self-Enforcing Model}

Assuming for the moment that securities regulation can ever be made self-enforcing, one might question the utility of the entire project. It is true that while the success of the U.S. regulatory model has created a strong securities market in the United States, such a model has been traditionally much less relevant in Japan under bureaucratic guidance that favored bank financing over equity.\textsuperscript{191} However, one argument would posit that the most effective structure of securities regulation largely depends on the legal culture and economic circumstances of the adopting state. With that in mind, evidence from several developing, post-Communist East European economies has indicated that a prohibitive, enforcement-intensive model inspires greater investor confidence and creates more vibrant markets and diffuse equity ownership than any alternative system.

The Czech Republic provides a remarkable parallel to the Russian experience. In 1991, the Czech government initiated a nationwide voucher privatization program very similar to Russia's program of 1994, leaving the enactment of concrete rules on investor protection and securities fraud for the time when the new owners would take control of the enterprises.\textsuperscript{192}

\begin{itemize}
\item \textsuperscript{190} \textit{Id}. at 1933–36.
\item \textsuperscript{192} \textit{See John Reed}, \textit{Trading Places: Cautious Poles Teach Laissez-Faire Czechs How to Build a Bourse}, WALL ST. J. EUR., Mar. 3, 1997, at 1.
\end{itemize}
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Subsequently, Czech fund-management groups began a series of takeovers, aided by weak market transparency and the ability of large investors to purchase substantial stakes without alerting other market participants or government regulators. The result was a consolidation of such holdings into a relatively small number of very large industrial holding companies resembling the Russian FIGs.\textsuperscript{193} Faced with a large but highly illiquid market and the prospect of takeovers, Czech companies opted for bank loans rather than equity financing.\textsuperscript{194} In comparison, tight regulation and enforcement of a stringent "prohibitive" model of securities regulation, which forbid everything not explicitly permitted, brought about a highly liquid and dynamic securities market in Poland.\textsuperscript{195}

While the Czech Republic is now attempting to recapture lost opportunities by enacting a more rigorous securities code based on the principles of disclosure and enforcement, the same ideal is not necessarily in Russia's best interests. First, Russia is a much bigger country and has a far larger economy than either Poland or the Czech Republic. Second, the impact wrought by nearly seventy-five years of socialism on Russia's economy, legal system, and mindset is more difficult to displace than the forty years undergone by its satellite countries. Third, and most importantly, if Russia has developed economically along the lines of the Czech Republic rather than of Poland, it does not necessarily follow that a reflexive reversion to a U.S.-style securities code will at once annul past mistakes and achieve market transparency, all the while boosting investor confidence. The Russian economy is not the \textit{tabula rasa} that Poland was at the dawn of post-Soviet reform and the Balcerowicz Plan.\textsuperscript{196} To create a strong securities market in

\textsuperscript{193}Id. Compare the experience of Russian FIGs, supra text accompanying notes 92–96 and note 106. According to one observer at the Prague Stock Exchange, the development of the industrial groups was merely the realization of common expectations: "The going philosophy was essentially Marxist: that the role of the stock market should be to bring about the concentration of capital." Reed, supra note 192.

\textsuperscript{194}Id. Still more redolent of the Russian experience is the fact that the investment funds involved in the takeovers were offshoots of Czech savings banks. As the more trusted institutions at the time, such banks were encouraged to set up the funds as a means of inspiring confidence in the privatization process. See Gray, supra note 21:

A somewhat surprising development has been the concentrated ownership and cross-ownership that has emerged from voucher privatization in the Czech Republic. Not only is ownership concentrated in a few funds, but individual funds often own shares of directly competing firms. Furthermore, the funds, together with affiliated banks, are locked in an intricate web of cross-ownership (or sometimes self-ownership) as a result of the privatization of the banks through vouchers. Thus banks are insulated from competitive pressures, and the government continues to influence the economy through its 40 percent (or greater) residual holdings of shares in privatized banks.

\textsuperscript{195}See Reed, supra note 192.

\textsuperscript{196}The Balcerowicz Plan, named after the Polish Finance Minister, was set in motion on January 1, 1990, as one of the first post-Communist "shock therapy" economic plans. While its concurrent attempts to cut inflation, end government subsidies and price controls, and privatize state enterprises are credited with Poland's rapid economic transformation, other
preference to the bank-dominated Japanese or German systems, Russia must acknowledge and co-opt the institutions that already exist and have a vested interest in the preservation of its current system, while pursuing greater disclosure by tight-lipped firms and promoting the active participation of individual investors. One possible way to achieve this lies through a self-enforcing model of securities law.

C. The Contours of a Self-Enforcing Securities Law

Perhaps sensing the difficulty of supporting and enforcing a prohibitive securities regulation model, the Russian President issued a decree in July 1996, charting a general course for the future development of such regulation. Most striking in juxtaposition to the highly prescriptive format of the 1996 Securities Law is the decree’s forthright acknowledgment of the ascendance of self-regulation as the controlling principle of government policy. The decree states:

The most important principles of government policy toward the securities market include: . . . (c) the principle of minimal government interference and maximum self-regulation, which means that the government regulates the activities of market actors only in cases where it is absolutely necessary, and delegates a portion of its rulemaking and controlling functions to the professional operators of the securities market, organized as self-regulating organizations. Subject to the realization of this principle, the government will act out of the necessity: (i) to minimize federal budget expenditures on the creation of market infrastructure; (ii) to decline the imposition of centralized decisions during the creation of market infrastructure . . . .

One might argue that the decree does not necessarily imply a sudden acceptance of self-enforcement and a rejection of the trend embodied in the 1996 Securities Law. The words of the decree, read as a kind of white paper, do not have the effect of a law, nor is there any way of enforcing them except through the normal course of legislation. The decree may also suggest an emphasis on an English model, in which the London Stock Exchange plays a dominant regulatory role on the market. However, a self-enforcing approach may still be seen as consistent with the general idea of the decree’s principle, insofar as it seeks to “compensate for the weakness of formal enforcement through a combination of relatively simple, bright-
line rules governing when its structural constraints apply, rules that insiders will often comply with voluntarily, and strong sanctions for violating the rules.\footnote{Black & Kraakman, supra note 13, at 1934–35.}

1. Bright-Line Rules

In a sense, the 1996 Securities Law already manifests several traits that render it self-enforcing. A side-by-side comparison of the 1996 Securities Law with the 1933 Act finds that whereas the 1933 Act is perhaps more compact and integrated in its overall structure, the 1996 Securities Law does a better job of setting out easy to follow instructions in checklist form.\footnote{For example, Article 19 of the 1996 Securities Law lists four stages preceding the issue of securities, then sets out a test for determining when an issue qualifies as a public placement, and finally adds an additional four stages necessary for a proper public placement (which include the preparation and registration of a prospectus, the disclosure of all information contained in the prospectus, and the disclosure of all information contained in the report on the results of the issue).} In places, it also sets out simple, bright-line rules against conduct uniformly condemned as improper, such as trading on inside information.\footnote{1996 Securities Law, supra note 1, arts. 31–33.} Yet, in many other instances, the 1996 Securities Law provides little guidance even for the most wary issuers. One particularly egregious specimen, already mentioned,\footnote{See supra text accompanying note 160.} involves the potential nullification of an issue “where [a] bad faith issue resulted in a materially significant delusion of the owners [of the securities involved], or if the purposes of the issue are contrary to the principles of law and order and morality.”\footnote{1996 Securities Law, supra note 1, art. 51(3). Even if the definition of a “bad faith” issue was free from ambiguity, there is nothing self-explanatory about a “materially significant delusion” or “principles of law and order and morality.”} In another, the language of the “exclusive” reasons for denial of registration in Article 59 of Decree No. 19 varies considerably from the language of a comparable set of reasons in Article 21 of the 1996 Securities Law.\footnote{See supra text accompanying note 158.}

Some rules are questionable as a matter of policy. For instance, the duty to correct disclosure arises when untruthful information contained in the prospectus has no material significance, or is of a technical nature.\footnote{See supra text accompanying note 162.} Several obvious question follow: why, if untruthful information is not material, should the issuer be required to correct it?\footnote{As an alternative, the FCSM might order correction of a falsehood in the proximately following quarterly report filed under Article 30 of the 1996 Securities Law.} Or, if accurate disclosure is a primary goal, why not state that any untruthful information that is inac-
curate when made is subject to immediate compulsory correction? This sweeping requirement would eliminate the need to define materiality, a puzzle worthy of U.S. courts willing to split hairs in crafting a serviceable denotation, but hardly conducive to clarity or certainty in the Russian context. As much as possible, materiality should be clearly defined if it is to be used at all. In the context of materially untruthful information, the trigger might be the fall of the price of securities by a certain percentage (e.g., twenty percent) over the course of fifteen working days beginning with the day on which the misrepresentation is discovered and divulged to the market.

The goal of disclosure should not only be market transparency for its own sake, but also to facilitate the participation of individual investors and the entry of small firms into the capital markets. With respect to individual investors, as contrasted with the sophisticated investors who are the main actors on the Russian securities markets today, it is probably correct to say that if some information is good, more is not necessarily better. While self-enforcement is promoted through the prospectus schedule provided at the end of Decree No. 19, smaller issuers or issuers placing securities of comparatively small aggregate offering price should have the option of not jumping through every single disclosure hoop applicable to issuers such as Lukoil and Norilsk Nickel. While this raises the likely problem of integration, Part III.C.2 offers a structural solution based on the maintenance of several trading systems.

A graduated approach to disclosure for smaller issuers ought not to suggest that the release of information to the marketplace should be voluntary, only that it should be tailored to the size and objectives of the disclosing firm. Evidence exists that once information about a firm is widely available and regularly supplied to the investor community, the incentive

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208 The Court of Appeals for the First Circuit made this argument in Backman v. Polaroid Corp., 910 F.2d 10 (1990), when it distinguished between a duty to correct seemingly any statements which are inaccurate when made, and a different duty to correct prior statements which have become materially misleading in light of subsequent events. Id. at 16–17 (emphasis added).

209 A further difficulty is the necessity of showing causation between such information and the slip in price. Because many different contemporaneous factors contribute to fluctuations in the price of a security, the link between the misrepresentation and the price fall may be very weak, if at all determinable. The danger of a no-fault rule regarding misrepresented information is that investors might take advantage of the rule by “sitting” on a discovered misrepresentation until the issuer releases a lower-than-expected earnings report, and then attribute the resulting price drop to the falsehood. One possible solution is to utilize a very short statute of limitations (say, three months) during which investors may bring an action citing misrepresentation.

210 See Easterbrook & Fischel, supra note 116, at 696.

211 See Decree No. 19, supra note 141, Addendum 3.

for market participants to employ other procedural rules increases also, so that little-used provisions of the 1996 Securities Law and the Joint-Stock Company Law become increasingly relevant. The Red October tender offer is one example. Having completed a Western-style initial public offering ("IPO") in December 1994, the company found itself at the center of the first Western-style hostile tender offer bid ever staged in Russia. The structure of the bid, orchestrated by Alliance-Menatep, the investment banking arm of Menatep Bank, and advised on by Western experts, was dictated by the high degree of transparency achieved by the IPO audit and company disclosure. Because a traditional, behind-the-scenes takeover was not possible, another approach was tried. The fact that the offer failed due to a combination of management strong-arming of employees and a poison pill does not diminish the larger point that high levels of disclosure are in themselves a partial lever for jump-starting the Russian securities market.

The graduated approach also makes sense in the particular climate that Russian firms face. Smaller firms, unlike companies already considered blue chips, do not have sufficient exposure to enable them to access the international capital markets. If the immediate costs of intrusive disclosure

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213 The results of the IPO were mixed. Both Russian institutional investors and foreign investors bought up their allotments. Russian retail investors, however, purchased only 16,000 of the one million shares allotted for them, despite their combined savings. See Julie Tolkacheva, Red October Share Offer: Not Sweet Enough?, MOSCOW TIMES, Dec. 20, 1994, available in LEXIS, World Library, Allwld File, cited in Brown, Brokers, Banks, supra note 24, at 212 n.165. One theory advanced by Professor Brown as to why retail investors were so disinterested in this IPO is that the sober projections in the Red October prospectus were unexciting by comparison with the giddy promises made by MMM and similar fraudulent enterprises. Yet it is also possible that with the MMM scandal already ended, Russian investors had become highly risk-averse even toward a company with superlative disclosure and accurate figures.

214 According to Alliance-Menatep’s CEO, Red October Stock was concentrated in the hands of small shareholders and a few big shareholders, with only 30% of the shares freely traded. See Natasha Mileusnic, No Trend After Menatep Hostile Bid, MOSCOW TIMES, Aug. 1, 1996, available in LEXIS, World Library, Allwld File.


It is unclear what the result might have been if the tender offer had been staged after the enactment of the Joint-Stock Company Law in 1995. Article 80 of this Law compels the purchaser of 30% or more of a company’s common stock to offer to buy out the remaining shareholders at a price not lower than the average weight price of the stock over the six months immediately preceding the date of the acquisition of the 30% or greater stake. In the same vein, the Joint-Stock Company Law has curbed the ability to stage a quiet friendly takeover, requiring a person who, alone or with his affiliates, intends to acquire 30% or more of the common stock of a company, to send a written application to the company divulging such intent no later than 30 days prior to such acquisition. See Joint-Stock Company Law, supra note 5.

216 See supra text accompanying note 103.
and registration are high, the only alternative options available to small firms might be to turn to the banks and spread comparably higher overall financing costs over a longer period of time, or else be denied investment capital altogether.\(^{217}\) Taking this into account, a self-enforcing model of securities regulation might emphasize a voluntarily diminished disclosure burden on smaller firms at the same time as it seeks the active participation of individual investors. From the standpoint of the FCSM’s limited resources,\(^{218}\) diminished disclosure requirements for at least some Russian firms will lower its burden of policing its own highly onerous and review-intensive disclosure rules. While there may not be anything particularly “self-enforcing” about this schema, its successful prevention of fraud and encouragement of retail investor confidence are, I believe, attainable through a set of self-enforcing structural constraints.

2. Structural Constraints

A reputation-based enforcement structure is at the core of the self-enforcing model here described. As noted previously,\(^{219}\) effective judicial enforcement of contract law (not to mention the 1996 Securities Law) is perhaps years away in Russia, and the presence of a business culture that stresses informal, extralegal relationships among market actors\(^ {220}\) stymies regulatory guidelines seeking to replace such behavior. The self-enforcing alternative might respond with a regulatory system that places its emphasis on building institutions to which market participants will adapt their transactions rather than those which they will ignore — or worse, those which over-regulate and throttle beneficial conduct.

a. Multiple Trading Systems

One such institution might be a product of already developing market infrastructure. The National Association of Stock Market Participants (“NAUFUR”) has installed a second trading system, RTS-2, as a counterpart to the Russian Trading System (“RTS-1”) already in place.\(^ {221}\) The

\(^{217}\) The prospect of this is not remote, given the banks’ conservative lending patterns and their reputation for risk aversion. See Brown, Brokers, Banks, supra note 24, at 216-217.

\(^{218}\) See supra text accompanying note 80.

\(^{219}\) See supra Part II.B.2.

\(^{220}\) See, e.g., Thane Gustafson & Daniel Yergin, Miracle In Russia 2010?, MOSCOW TIMES, Oct. 30, 1996, available in LEXIS, World Library, Allwld File (“[B]oth property rights and financial stabilization are still highly fragile. Most of the protection for private property is still ‘extra-legal’; that is, it comes from protection by politicians and mafiosi.”). As Katharina Pistor notes, the sources of the semi-legality of market transactions include the existing tax system and restrictive regulations, as well as clandestine profiteering on transaction-related asset stripping and side payments. See Pistor, supra note 68, at 84.

principle distinction between the two systems is that companies that trade on RTS-2 need lower capitalization levels and must satisfy lower disclosure requirements than their counterparts on RTS-1.\textsuperscript{222} The system permits low-liquidity securities to be quoted on an exchange, and, most importantly, allows securities to move from RTS-2 to the more established RTS-1 once they achieve a certain level of disclosure and liquidity, as well as move in the opposite direction if disclosure and liquidity decline.\textsuperscript{223}

Provided that it undergoes some regulatory improvements,\textsuperscript{224} RTS-2 promises to become a part of a reputational mechanism that gives investors some idea of which companies offer informational transparency, which are liquid, and which are not. The systems act as a kind of informal rating agency. In promulgating rules for the trading systems, one beneficial feature would be the creation of an explicit connection between the level of disclosure and trustworthiness of a company, and its listing on either RTS-1 or RTS-2. Instead of administrative action resulting in fines or issue nullification on the basis of “law and order” or morality principles, enforcement of particularly egregious or recurrent misrepresentations or omissions in disclosure may involve the transfer of a company’s securities from a “higher” trading system to a “lower” one.\textsuperscript{225} The goal would be, in part, to attach a certain stigma to being listed on the lower-ranked system, and to make investors aware of the reasons why a firm’s securities trade on one system rather than another.\textsuperscript{226} An explicit association of higher risk and

\textsuperscript{222} See id.; Proskurina, supra note 24. RTS-2 has been successful in attracting companies despite misgivings that many will not be actively traded. As of early March 1997, RTS-2 listed 74 securities in comparison with 89 for RTS-1. See RTS And RTS-2 Listing Revised, NOVECON, Mar. 5, 1997, available in LEXIS, World Library, Allwld File. The disclosure requirements include an application and a balance sheet for the last accounting period. The capitalization floor is approximately U.S. $900 (R5m), as compared with U.S. $5,000 (R28m) on RTS-1.

\textsuperscript{223} See Olga Popova, New Russia Shares Market Widens Investment Horizon, REUTER EUR. BUS. REP., Feb. 12, 1997, available in LEXIS, World Library, Allwld File. Notably, such “downgrading” and “upgrading” movements of companies between RTS-1 and RTS-2 have already begun, with the concomitant perception of a company’s move to RTS-1 as a boon to its liquidity and credibility. In March 1997, for example, two regional power companies, Kubanenergo and Kolenergo, were upgraded to RTS-1, while the Far Eastern Shipping Company’s financial troubles and loss of liquidity contributed to its slip to RTS-2. See Durham, supra note 83, at 96.

\textsuperscript{224} For example, federal law does not require brokers to immediately report trades, and clients rarely do so either. This results in wide spreads and transparency problems. See, Popova, supra note 223.

\textsuperscript{225} This statement is not to say that other administrative sanctions may not also be appropriate in certain situations. The emphasis on “trading system” enforcement, however, will be more visible to investors than a fine, and less severe than issue nullification.

\textsuperscript{226} Because firms trading on the “lower” system would by the same token be more risky, the FCSM might consider strictly limiting the amount of “soft” information and rosy earnings projections that such firms will be tempted to make.
minimal disclosure efforts with placement on a “lower” trading system would serve roughly the same function as a Standard & Poor or Moody’s rating in the United States.\(^\text{227}\) Along the same lines, NAUFUR and the FCSM may consider the introduction of a third trading system, with threshold capitalization and disclosure requirements halfway between those of RTS-1 and RTS-2.\(^\text{228}\)

b. Issuing Abroad and At Home

One of the more promising recent methods of policing the opportunistic behavior of Russian issuers owes little to the watchful administration of existing laws by the FCSM, the procuray,\(^\text{229}\) or the courts. Rather, a semi-strong check on securities abuses is here a product of the placement of securities with foreign institutional investors and the listing of these securities on overseas exchanges.\(^\text{230}\) Russian companies that do so may be as interested in preserving the value of their reputational capital as they are keen to grow the more tangible kind, particularly if they plan on returning to the international markets in the future. The check may be temporary, but it is undoubtedly present. Several factors explain its existence. First, Russian institutional investors tend to “buy to control assets, not to take a portfolio view on companies’ potential long-term growth.”\(^\text{231}\) Second, the Russian

\(^{227}\) Perhaps taking its cue from the NAUFUR initiative, the FCSM has announced plans to establish minor trade floors on existing stock exchanges for risk-averse, small-scale investors in Russian stocks. The trading floors are to function as more accessible alternatives to the Russian Trading System (where trades are carried out by professional brokers in minimum lots of $5,000). See Russian FSC Set to Improve Conditions for Private Investors, NOVECON, Apr. 21, 1997 (reprinted from Delovoi Mir, Apr. 17, 1997), available in LEXIS, World Library, Allwld File.

\(^{228}\) The advantages for smaller firms that start out disclosing less than the full salvo of information currently required by the 1996 Securities Law are several: first, investors will be aware of such firms’ securities and will be able to roughly gauge their value without becoming unnecessarily involved in difficult individual monitoring; second, such firms, particularly if they are just starting up, are already sufficiently risky investments as not to be exceptionally disadvantaged by being associated with similarly risky firms on RTS-2; third, a long time spent on a lower-ranked system without any upward movement would send a clear signal about the openness of a firm’s management, just as an extended presence on a higher-ranked system would give the impression of a firm’s commitment to transparency and fair dealing; and fourth, it would leave to the individual firm the decision on how to balance the costs of disclosure against the benefits of a presence on a higher-ranked RTS.

\(^{229}\) Procuracy (“Prokuratura” in Russian) is roughly comparable to the U.S. District Attorney’s Office, i.e., the prosecution in criminal cases.

\(^{230}\) See supra text accompanying notes 42–44.

\(^{231}\) See Lee, Russian Winter, supra note 16, at 54 (quoting Charles Harman of MC Securities). The frenzied scramble for control of Russian assets, as seen, for example, in the 1995 loans-for-shares auction, revealed a common motive on the part of Russian company managers, politicians, and banks to keep share prices down, enabling them to purchase large stakes as cheaply as possible. Id. at 53.
equity market is, in the view of one observer, "entirely driven by foreign
capital," with foreign investors purchasing stakes openly where possible
or by circuitous means where necessary. Because placements outside Russia require a substantial upgrade in the
quality of a firm's informational disclosure, a self-enforcing approach
might require a company that issues and/or lists its securities overseas to
simultaneously make the issue available for purchase by domestic investors,
particularly retail investors and mutual funds. This requirement would offer
domestic investors the opportunity to acquaint themselves with — and pur-
chase the shares of — companies that have a lot to lose from downgrading
their reputational capital through flagrant misrepresentations or fraudulent
activities. As in the United States, a retail investor's best protection will
often be an alignment of his interests with those of a foreign institutional
investor who owns the same stock. The converse may also hold true. When a Russian firm plans a distri-
bution to the domestic market, a self-enforcing law might require it to place
a portion of the issue with foreign investors, or list on a foreign exchange
that has a certain minimal disclosure requirement. For both types of issu-
ers — those who want to issue abroad as against those who plan to issue at
home — the FCSM must carefully weigh several factors. Some firms may

232 See Caplen, supra note 44, at 9 (citing Eugene Tanenbaum of Salomon Brothers).
233 Gazprom, a Russian company holding one-third of the world's known gas reserves, is
considered a strategically important concern and is restricted to a quota of 9% on foreign eq-
uity ownership. Nevertheless, some Moscow-based investment banks have been establishing
Russian-registered companies to purchase additional Gazprom shares on behalf of foreign
clients with rumors of tacit approval by Gazprom management. See John Thornhill, Playing
(1996), which states that in connection with the appointment of a lead plaintiff to head a
class action in private securities litigation, "the court . . . shall appoint as lead plaintiff the
member or members of the purported plaintiff class that the court determines to be most ca-
pable of adequately representing the interests of class members . . . ." The Act was drafted
on the assumption that the plaintiffs having the most at stake in a litigation, as well as the
ones having the most capable, least self-interested counsel, will most often be institutional
investors, and such investors will therefore generally be "most capable of adequately repre-
senting the interests of class members."
235 This structural constraint is supported by the recent resolution of the Surgutneftegaz
controversy, in which Surgut Holding diluted shares in the Surgutneftegaz Oil Company by
purchasing an entire issue of its shares at below-market prices without offering the same op-
portunity to the company's other shareholders. The FCSM successfully pressured Surgut
Holding to pay an additional $36 million for the shares, but only as a result of indirect inter-
vention by the SEC, then considering an application by Surgut to issue ADSs in the United
States. See Peter Henderson, Russian Shareholder Problems Remain Post-Mosenergo,
Although the sum paid by Surgut Holding was still below market price, Surgutneftegaz also
agreed to amend its charter, giving shareholders preemptive rights over future share issues.
See Durham, supra, note 83, at 99.
be exceedingly high investment risks, to the point where a placement on the international markets may be impractical.\textsuperscript{236} Such firms might also have the option of listing their securities on a lower-ranked trading system in exchange for a lessened disclosure burden. Self-enforcement ought not to require doctrinal rigidity as a substitute for good sense: it may exclude firms below a certain capitalization from the requirement of issuing overseas, despite the fact that such firms are excellent candidates for co-monitoring by international investors. The FCSM will also need to decide what percentage of each firm’s intended total placement will be made overseas (or conversely, at home), and what factors undergird such calculations.\textsuperscript{237}

It is unnecessary for the self-enforcing model to make mandatory listing or placement of securities on the international capital markets a permanent feature of Russian securities law. The model’s efficiencies are realized from the harnessing of the regulatory structures of more mature economies, the developed enforcement and monitoring capacities of sophisticated foreign investors, and the valuable reputational capital that firms planning returns to the international capital markets have at stake. As the Russian legal system matures and becomes capable of policing refractory Russian firms,\textsuperscript{238} this system of enforcement will become unnecessary. But in the interim, self-enforcing regulations such as this one can provide the necessary groundwork for gradually attracting retail investors back into the mar-

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\textsuperscript{236} A foreign placement may, for example, be rejected by non-Russian investors either entirely or partially. The foreign placement would then be little more than punitive, as the costs of the extra due diligence, documentation, auditing, and counsel would exceed the revenue earned from the distribution.

\textsuperscript{237} Beyond capitalization, one might consider a non-exclusive list of such items as past experience in issuing to international capital markets, the listing of a given firm’s securities on foreign exchanges, the length of time such securities were listed without undergoing any disciplinary actions by foreign regulatory bodies, and the number and seriousness of recent disciplinary actions by the FCSM.

\textsuperscript{238} It is possible to argue that blaming the Russian courts for the inadequacy of enforcement of current laws reflects an unsupported bias in the Western media. See, e.g., Bauer, supra note 18, at 373 (“[W]hile incompetent judges, bribed officials and private law enforcement can be found in today’s Russia, what often remains untold is that there is, against all odds, a functioning system with hard-working people trying to overcome all these difficulties.”). However, even a system of competent judges and efficient courts would have an extremely difficult time overcoming the legacy of private dispute resolution left over from the extra-legality of Soviet-era black market transactions. In addition, the evasion of the taxes remains an acknowledged problem. See March 5 Press Conference, supra note 61:

If the tax issue remains in its present state, everything will go into offshore operations. We wouldn’t be able to stop the process. We can tighten border controls and post 10 policemen, but the money will still escape. So, taxes above all, are the key. And we should not tolerate the provisions that are in the Tax Code now . . . .

And, perhaps most crucially, many securities violators will never face sanctions unless the 1996 Securities Law provides an explicit private right of action for retail investors. See id.
market with minimal reliance placed on domestic enforcement mechanisms still unfit to execute their critical policing roles.

c. The Taming of the FIGs

According to Professor Brown, unless Russia undertakes the kind of strict separation between the commercial and investment banking sectors maintained in the United States under the Glass-Steagall Act, a bank-dominated corporate finance system will emerge, stifling the Russian securities market and slowing economic development. Consistent with this argument, the FCSM has initiated an active licensing campaign for market participants, allegedly with the express intention of building the Chinese Wall that Professor Brown envisions. The construction of this elaborate regulatory edifice, however, is of dubious value regardless of its likelihood of success. Even at its U.S. wellspring, the separation between commercial banking and the securities industry has been repeatedly questioned. A similar separation in Russia will undoubtedly produce another regulatory quagmire that the FCSM will have to police in addition to all its other functions. Moreover, it will exacerbate unnecessary friction between the FCSM on the one side, and the banks under the regulation of the Russian Central Bank on the other. The FCSM does not need to wage a political

\[239\] See Brown, Brokers, Banks, supra note 24, passim.

\[240\] See FSC's Thumb on New Market, MOSCOW TIMES, Mar. 11, 1997, available in LEXIS, World Library, Allwld File (“[FCSM Chairman] Vasilyev . . . is fond of the American model, which prohibits banks from conducting transactions directly on the securities market. Moving in that direction, the [FCSM] is planning to limit banks' trading of corporate bonds.”) Vasilyev has confirmed his intention of re-licensing professional market participants, as well as intensive policing of licensing violations:

*The fundamental task of 1997 is to create a system of licensing and control over the activities of all professional participants on the securities market. In 1996 we raised the issue of registrars. In 1997 we should re-register all brokers and dealers, re-register exchanges, the depositary system should develop, we should license depositaries and, most important, a regular system of control has been created. A system of control and verification. We cannot limit ourselves just to the issuance of licenses. This is not enough and this will never suit us. The might of the Western securities markets rests on constant control effected by corresponding commissions.*


\[242\] See FSC's Thumb on New Market, supra note 240. Contrary to his subsequent advocacy of a Glass-Steagall-type legislation for Russia, Professor Brown has written elsewhere that “[p]residential decrees or Duma-adopted laws . . . 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.” Brown, Order from Disorder, supra note 97, at 552.

\[243\] Banks have complained that the FCSM’s efforts to act as the sole licensor of depositaries have been ill-conceived attempts to edge banks out of the custodial market. See Federal Commission Issues Rules on Disclosure, Custodial Services, WORLD SEC. L. REP., Dec. 1996, at 8–9. As regulatory watchdog of the banks, the Central Bank too has railed against
turf war in addition to enforcing the multitude of regulations it has already put in place.244

If it were to “win” by effectively ejecting Russian banks from the securities markets, the FCSM might perhaps preserve both the commercial lending and securities market channel for the flow of financing to industry. If it did so, the FCSM would act at the expense of an alternative system, such as Germany’s, where commercial banks actively monitor companies by owning substantial stakes and voting shares which they hold as custodians.245 It is unclear which system — one dominated by the securities market or by banks — is inherently better. In the case of Russia, with its distinct set of political and economic institutions, its immense economic potential, and its history of centralized oversight, perhaps neither is best, and the two systems should be allowed to compete,246 without permitting either side to monopolize the system.247 The challenge, then, is to keep the banks from dominating the process of raising capital without cutting off their valuable ability to act as corporate monitors. The U.S. alternative would unnecessarily involve the FCSM in needless political infighting and burdensome additional enforcement duties based on a highly debatable ideological position. The adoption of a bank-dominated European or Japanese alternative would swing the pendulum too far in the other direction, so that a few dominant banks would provide the Russian government with an irresistible target for intrusive regulatory intervention.248
With this situation in mind, a self-enforcing approach might co-opt the
cross-shareholding groupings being formed around the leading Russian
commercial banks. The FCSM may subject the controlling stakeholders in
issuing companies to joint-and-several liability for misrepresentations or
omissions in disclosure, or for other abuses on the part of management. A
hypothetical rule would state that in exchange for affiliate status, a
stakeholder and its affiliates will be jointly-and-severally liable for the vi-
lations of the securities laws by the issuing company. Moreover, the rule
might require that a company which by itself or together with its affiliates is
capitalized at more than U.S. $500 million and which takes a controlling
stake in a firm must ensure that within eighteen months such firm is eligible
to be listed, and is listed, on RTS-1, or the system or exchange requiring the
most complete informational transparency and integrity from its partici-
pants.

It is of course arguable that this heightened liability for Russian com-
mercial banks will be an even greater incentive for banks to prevent the
firms they control from issuing securities and disclosing to the market; in-

249 I am indebted to Professor Reinier Kraakman for suggesting this idea.

250 To my knowledge, the definition of "affiliate" common to U.S. securities laws has not
yet been put to meaningful use in Russia. Despite the fact that the Joint-Stock Company
Law mentions affiliates in Articles 89, 92, and 93, it defines "affiliate" by reference to the
definition in RF antimonopoly legislation. However, the only current definition of an affili-
ated person is provided by the Presidential Decree No. 1186 (1992) on investment funds [O
Merakh Po Organizatsii Rynka Tsennykh Bumag v Protsesse Privatizatsii Gosudarstvennykh
i Munitsypal'nykh Predpriatij], Article 4, which states that "affiliated persons" include a
company's CEO, directors and other officers, its founders, shareholders that own 25% or
more of its shares, or any enterprise of whose voting shares the company owns 25% or more.
Antimonopoly legislation, by contrast, defines "legal entities controlling each other's prop-
erty" (juridicheskie litsa kontrolирующие имущество друг друга) but not "affiliated per-
sons" (affilirovannyе litsa). "Legal entities controlling each other's property" are defined as
legal entities that have no opportunity to control each other's activities by virtue of (i) own-
ership by one legal entity of 25% of (probably not only voting) shares in another entity; (ii)
ownership by one legal entity of any number of shares conferring rights to cast 50% of the
votes in another entity; or (iii) having at least one-fourth of the same individuals as elected
officers in common among different legal entities. See "Instruction on the Procedure of
Controlling Acquisition of Shares of Partnerships and Common Registered Shares of Joint
Stock Companies and the Procedure of Considering Persons as Controlling Each Other's
Property," State Antimonopoly Committee Decree No. 5, § 7, Jan. 18, 1994; Olga Sirodoeva,

Because the Joint-Stock Company Law is not moored to this or any other definition of an
affiliate, its affiliate-related provisions are devoid of meaning. Hence, the first step would be
to instate a workable and consistent definition of an affiliate that can be incorporated by ref-
ference into a variety of legal acts, or enlist the concept provided by the antimonopoly legis-
lation.

251 The number is hypothetical, but must represent the capitalization of a commercial
bank and the members of its industrial group.
stead, the banks might be tempted to meet the capital needs of such firms with syndicated loans. This argument overlooks the fact that the most attractive targets of acquisition — the firms with the largest prospects for growth and the most extensive access to raw materials such as oil and gas — are the very same firms that require billions of dollars each in capital improvements and modernization in order to be profitable. It is unlikely that even the well-heeled Russian banks can coordinate loans on such a gargantuan scale, particularly if they plan to make further acquisitions.

This structural regulation is not meant simply as a stick to beat over the heads of the banks and their keiretsu partners. It offers substantial rewards in exchange for the risks imposed. If they are serious about acting as legitimate corporate monitors, Russian banks can continue to acquire and hold controlling stakes in firms provided that, through active monitoring of company management and vigorous encouragement of company transparency, they increase the liquidity of the securities that such firms issue. By doing so, the banks will benefit in the long-term by raising the share prices of such firms’ securities, drawing in retail investors, and promoting confidence in the Russian securities markets. They would also be able to more easily rid themselves of their stakes in loss-making enterprises, rather than subsidize them with funds from profitable companies in their respective banking or industrial groups. Once such companies are cut adrift, they will have a securities market to fall back on, if and when they attempt to restructure themselves. Without such a safety net in place, the Russian

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252 See The Year of the Bond, supra note 60, at 90 (“Russian entities all have a significant capital requirement, . . . [a]nd there is not the money in Russia to meet that. Companies are not going to raise large sums of money — either from Russian banks or from Russian institutional investors, because it is just not there at the moment.”). For example, Gazprom’s planned pipeline from the Yamal gas field to the West alone is expected to cost between $15 billion and $40 billion. See Barraclough, supra note 45; Lee, Russian Winter, supra note 16.

253 This set of facts is only tenuously analogous to the situation in the United States at the end of the nineteenth century. It is possible that U.S. bank syndicates could have provided adequate credit to American industry, were it not for a concerted political mistrust of the power of commercial banks. As a result of the National Bank Acts of 1863 and 1864, banks were confined to a single geographic location. Additionally, in California Bank v. Kennedy, 167 U.S. 362 (1892), the Supreme Court denied banks the right to own stock in corporations. Banks were consequently shut out of any meaningful controlling or monitoring role because no single bank was capable of providing the necessary financing to even a single large U.S. industrial company. See Roe, supra note 245, at 54–55. Today, even within bank-centered Japanese keiretsu, less than half of a firm’s borrowed funds come directly from a main bank. Rather, loan syndicates are the sources of a majority of loans to Japanese companies. See Macey & Miller, supra note 101, at 63 n.24 (citing Horiuchi, The Effect of Firm Status on Banking Relationships and Loan Syndication, (Universita Degli Di Siena, Quaderni Del Dipartimento Di Economica Politica) (1994) at 20–21 & Table 11.

254 The absence of a vigorous non-bank capital market in Japan has led to much more painful consequences for many firms whose relationship with their main lender banks were opportunistically terminated by such lenders. The banks do not make legally binding prom-
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government might be tempted to enforce a regulatory system that would selectively pressure banks to save failing firms. In view of Russia’s history of state involvement in the market, this new intrusion would be especially lamentable.

The regulation of banks in Russia should also take into account the implications of bank-dominated capital markets on smaller firms. Large firms have traditionally had easier access to funds because they could alternately turn to banks or securities markets for capital. With respect to smaller firms, however, the European experience is more indicative. Since 1995, the introduction of six new European secondary markets has propelled a number of IPOs by high-tech companies starved for investment. Beyond sorely-needed cash, access to these markets has enabled smaller firms to secure the kind of visibility among investors and customers which American firms have long enjoyed.

Encouragement of multiple trading systems and enrollment of banks as both company monitors and facilitators of disclosure to the securities markets are therefore particularly important for large Russian firms whose managers are more apt to ignore or betray small shareholders. With respect to smaller firms, weak securities markets and bank domination of the capital raising process are often a recipe for underdevelopment through capital starvation. Carefully crafted structural constraints on the securities market, commercial banks, and corporate management should seek an optimal balance between overintrusive intervention and vague default rules that provide little guidance for market participants. It is certainly arguable that the “self-enforcing” approach to securities regulation in Russia does not generate such optimal conditions. The main virtue of the self-enforcing approach, however, lies in its awareness of the characteristics and concepts

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\textsuperscript{255} See Milhaupt, \textit{supra} note 191, at 36–37, 45–46.
\textsuperscript{256} The Japanese Ministry of Finance has periodically exerted precisely this pressure on Japan’s banks. See \textit{id.} at 38.
\textsuperscript{257} See supra text accompanying notes 100–03.
\textsuperscript{258} See \textit{generally} Brown, \textit{Brokers, Banks, supra} note 24, at 218–219 (discussing the advantages to smaller firms having a strong securities market when operating with bank domination of the capital-raising process).
that distinguish Russia from the United States, Japan, or continental Europe, and that distinguish Russia’s nascent market infrastructure from their highly path-dependent economies and regulatory frameworks.260

IV. LIMITS OF THE SELF-ENFORCING MODEL AND CONCLUSION

Self-enforcement does not by any means seek to displace the key roles played by the FCSM, the Russian courts, and the Russian government. Nor does it purport to de-emphasize clear rules in favor of some invisible hand guiding self-regulating market institutions in the pursuit of mutual gain. On the contrary, the model’s dominant principle is the clarification of rules and laws, and the elimination of drafting ambiguities wherever possible. Securities regulation constructed on self-enforcing principles obviously cannot succeed without strict enforcement of those rules that it does introduce. Given clear rules and unambiguous principles, such enforcement can be appropriately heavy-handed,261 but only as long as sanctions and remedies are explicitly defined, not left to be developed by the courts on a case-by-case basis.262 Concepts like “material” information or “grossly negligent” disclosure offer no baseline for comparison with other instances of similar violations, and provide an issuer with little assurance of their evenhanded and consistent application by the courts or other enforcement agencies.263

Yet clarity of language is only a halfway measure. The other central concept of the self-enforcing model relies on structural constraints that co-

260 In an article by Professors Macey and Miller, supra note 101, at 71–72, the authors argue in favor of a level playing field for the U.S. commercial banking sector as well as for capital markets in Germany and Japan. They reason that nearly a century of retarding legislation has eliminated the danger that U.S. banks might intervene in corporate governance and stifle capital markets; neither U.S. institutional investors nor U.S. companies would today countenance such intrusion.

Without such institutional investors, and without well-developed capital markets to facilitate hostile takeover bids as restraints on blatant mismanagement or self-dealing, it is not clear that the same hands-off approach would benefit Russia. Few if any path-dependent variables can today restrain the comparatively strong Russian banking sector from staking out a dominant role in corporate governance and smothering a nascent securities market unless the Russian government actively pursues a contrary policy. Such a policy will succeed only if it treats both the banks and securities market participants evenhandedly while recognizing the strengths and motivations of both sides.

261 Heightened severity of sanctions is justified not merely by the fact that clear regulations leave less room for misunderstanding or misinterpretation, but also as compensation for the cost of discovering the violation. See Black & Kraakman, supra note 13, at 1972.

262 See id. at 1971.

263 The Joint-Stock Company Law, for example, does not impose liability on directors for decisions made in good faith, but rather for decisions made recklessly or with gross negligence. The reason is a lack of confidence in the ability of Russian courts to determine what conduct is “grossly negligent” under the circumstances. The Law also seeks to encourage managers to take long-term risks despite the absence of readily available information. See Black & Kraakman, supra note 13, at 1973.
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opt already viable institutions to police firms and their affiliates, and increase investors' confidence in the securities market they have so far shunned. The tripartite framework of multiple trading systems, compulsory issuance on the international (or alternatively, domestic) markets, and active policing of firms by their affiliated commercial banks constitutes a nonexclusive set of self-enforcing arrangements. With respect to banks, the optimal goal would be to align their interests with the interests of shareholders, ensuring that banks progressively see themselves as, and act like, very large shareholders rather than as fixed claimants only. In developed economies, such a framework would rightly elicit opposition as unnecessary, intrusive, and arbitrary. In Russia, the framework compensates for the absence of adequate resources or experience among the administrative and judicial bodies charged with regulating the securities market, as well as the persistent hostility of many managers to minority shareholders.

Most importantly, perhaps, the self-enforcing model should be above politics and ideology. It should serve primarily as a vehicle for the efficient allocation of capital and the protection of all investors, given the prevailing institutional pressures and inadequacies. Before attempting to implement one or another of the model's rules, careful attention should be given to three equally important considerations: does the rule make good economic sense; will it be enforceable; and will it be effective in reaching the desired policy goal. In the final view, a self-enforcing model of securities regulation is neutral as to which policy it effectuates.

There is a large measure of folly in cloning one country's laws on the basis of another's without giving appropriate thought to the highly idiosyncratic set of actors on which such laws will operate, or the consequences if they fail. The success of Poland's regulatory system does not, as I have argued above, provide a template for Russia, even though its economy and development since the breakup of the Soviet Union bear a much stronger resemblance to Russia's today than to the United States during the 1930s. The Joint-Stock Company Law and the self-enforcing model on which it is based have begun the transformation of Russian corporate law with due attention to Russia's characteristic challenges and problems. While its success is by no means certain, the model holds out hope of curbing the abuses and opportunistic behavior of managers and directors within the specific context of Russia's industrialized, but only recently privatized, economy. Some of the flexibility of the enabling model of corporate law found in the United States and England is sacrificed in favor of an emphasis on clear rules and enforcement through structural means. Insofar as the 1996 Securities Law envisions a strong, transparent securities market open to all potential investors, a self-enforcing approach seeks to ensure that this vision is not defeated by a facile duplication of another country's regulatory system.

264 See supra text accompanying notes 193-96.
It is important now to “get right” the regulatory and market system being created in Russia, for it just may be the system that reminds its creators of their mistakes for decades to come.