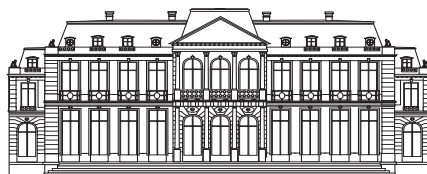


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**Conference on**

**“CORPORATE GOVERNANCE IN RUSSIA”**

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**“Protecting investors and the integrity of the markets: a review of the Federal Securities Commission’s (FSC) work related to corporate governance and disclosure”**

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# Conference on “Corporate Governance in Russia”

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## **Protecting investors and the integrity of the markets: a review of the Federal Securities Commission’s (FSC) work related to corporate governance and disclosure**

### **1. Legal Acts Regulating the Disclosure of Information During the 1991 to 1996 Period**

The first acts dealing with the disclosure of information by Russian issuers of securities made their appearance in 1991. That year the “Decree On the Issue and Circulation of Securities and the Stock Exchange in the Russian Federation” was enacted and continued to be the regulatory core for Russia’s securities market until the passing of the Federal Law On the Securities’ Market in 1996.

The above Decree (referred to in the text below as Decree # 78) for the first time in Russia’s legislation envisaged the registration of a prospectus on an issue. In accordance with the Decree, the registration of a prospectus was to be carried out when an open public subscription takes place, as well as with private placings if the securities are offered to more than 100 investors (or if the number of investors is likely to exceed 100 as a result of such a placement), or for amounts in excess of 50 million roubles (or if the amounts subscribed to as a result of such placements of securities exceeds 50 million roubles).

These rules did not apply to shares, distributed at the incorporation of joint-stock companies, while the Ministry of Finance was granted the privilege of waiving the registration prospectus requirement on certain issues with private offering.

The right to establish rules on the issuance of the prospectus, its registration and contents was accorded to the Ministry of Economics and Finance of the Russian Federation (later – the Ministry of Finance), while the same for the banks was controlled by the Ministry of Finance of the Russian Federation together with the Bank of Russia.

In accordance with Decree #78, Instruction #2 of the Ministry of Finance of the Russian Federation was adopted governing The Rules on the Issue and Registration of Securities on the Territory of the Russian Federation dated March 3<sup>rd</sup>, 1992, as well as an Instruction from the Bank of Russia - The Rules on the Issue and Registration of Securities by Commercial Banks on the Territory of the Russian Federation, dated February 11<sup>th</sup>, 1994. Somewhat later the Ministry of Finance adopted Instruction #59 On the Rules, Governing the Submission by the Issuers of Securities of Reports on the Results of the Undertaken Issues and on the Rules of Compilation and Submission by Joint-Stock Companies of Annual Reports Concerning the Securities, dated May 5<sup>th</sup>, 1994.

These were the documents which effectively proscribed the obligation of an issuer to submit quarterly reports on the results on the issue of securities. In accordance with the instructions of the Ministry of Finance quarterly reports on the results of the issues were to be submitted during the length of an issue, as well as after the first quarter, following the completion of an issue. Subsequently, the issuer was instructed to submit yearly reports concerning the securities. Such yearly reports were obligatory for all issuers of securities. The yearly report on the securities was to be published by an issuer simultaneously with his regular yearly report. Thus the report was to become an available periodic source of information about the issuer.

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<sup>1</sup> **The views expressed in this paper are those of the author and do not necessarily reflect those of the OECD**

The Bank of Russia in its instructions established a still stricter control which envisaged not just a simple submission of a report on issues, as was the rule with other issuers, but also required its registration. Additionally, it was envisaged that neglect to submit a report or its delay or non-conformity with established requirements offered grounds for proclaiming an issue void.

It should be noted that requirements, governing the issue of a prospectus were rather superficial, while demands on the report on securities were even less stringent. Owing to the above they could not serve as a satisfactory source of information for investors. On top of that controls over the disclosure of information was quite ineffective. Partially it was owing to this fact, that neglect of the rules on the disclosure of information was widespread.

## **II. Acting Regulations on the Disclosure of Information**

The Federal Law On the Securities' Market was passed in 1996. This Law presently acts as the regulatory mainstay for non-government securities in Russia.

The Law, same as the preceding official acts, requires registration of all securities regardless whether they are placed publicly or not, thus maintaining the traditional Russian legal basis for the disclosure of information.

The categorical and sequential legal demand regarding registration of securities' issues prompted courts to come in 1998 to a categorical conclusion that deals with unregistered securities are void and nil (see Information Review by the Presidium of the Supreme Court of Arbitration #33, dated April 21<sup>st</sup>, 1998, on the Report on Court Practices in Dealing with Cases of Placing and Circulation of shares).

Nevertheless, despite the rigid requirements of the Russian legal acts, avoidance of registration is still widespread. Namely, the requirement of registration of shares of private joint-stock companies always led and continues to cause surprised faces of a multitude of directors and of many practicing jurists.

The Federal Law On the Securities' Market introduced the notion of "information disclosure". In accordance with Article 30 of the Law, it is specified that the term "information disclosure" means "its availability to all interested parties, regardless of the aim of obtaining it, under the proceedings, guaranteeing its address and obtainability. The Law contains some definitions on the procedures of the disclosure of information, but on the whole the issue of its establishment is left in the competence of the Federal Securities Commission (FSC).

A dominating portion of the acts, which regulate the disclosure of information by the issuers, is at present regulated by the FSC. The principle legal acts of the FSC which in some way deal with disclosure of information, are as follows:

- Standards on the initial issue of shares at the founding stage of a joint-stock company and of the issue of additional shares, bonds and prospectuses (approved by a decision of the FSC #47, dated November 11<sup>th</sup>, 1998);
- Standards on the issue of shares and bonds and of their prospectuses at the founding stage of a commercial organization (approved by a decision of the FSC #48, dated November 11<sup>th</sup>, 1998);
- Instruction on the quarterly report by the issuer of securities (approved by a decision of the FSC #31, dated August 11<sup>th</sup>, 1998);
- Instruction on the disclosure of information on substantive facts (events, proceedings), having effect upon the financial and business activity of the issuer of securities (approved by a decision of the FSC #32, dated August 12<sup>th</sup>, 1998);

- Instruction on the sequence and detail of the information disclosed by public joint-stock companies when offering subscription to shares and securities,
- convertible into shares (approved by a decision of the FSC #9, dated April 20<sup>th</sup>, 1998);
- Instruction on the system of disclosing information on the securities' market (approved by a decision of the FSC #2, dated January 9<sup>th</sup>, 1997).

Requirements on the disclosure of information are at present set by the Bank of Russia.

### **Disclosure of Information with the Issue of Securities**

The passing of the Federal Law “On the Securities’ Market” brought about some changes to the procedure for the registration of the prospectus. The Law established that the registration of securities should be followed-up by registration of the prospectus with the initial flotation of securities among an unlimited number of investors, or among a specified list of investors in excess of 500, or should the issued capital exceed 50 thousand minimal wage levels.

Requirements on the prospectus are partially covered by Article 22 of the Law. But detailed requirements as to the form and contents of the prospectus are determined in the emission standards, established by the FSC. In accordance with these requirements the prospectus contains five parts: Part A: General Information on the Issuing Company; Part B: Statement of the financial position of an issuer; Part C: Information on previous securities issues; Part D: Information on issues in progress; Part E: Additional information. (See Addendum 1 for additional requirements on the content of prospectuses of organizations other than credit entities).

Article 23 of the Federal Law “On Securities’ Market” requires the issuer and the professional members of the stock exchange, participating in the flotation, to ensure availability of information, contained in the prospectus, prior to their purchase.

Apart from the above, in cases of public subscription the issuer is obligated to publish a notice on the order of disclosing information in a regular periodical with a circulation of at least 50 thousand copies.

Article 30 of the Law contains a provision forbidding flotation of new issues earlier than two weeks after the information on the expected flotation, required by the above Law, has been made available to all potential investors. The flotation standards, prescribed by the FSC, emphasize that this rule is obligatory in cases of public subscription, as well as that the two-week period is to be considered as of the moment of the information disclosure on the registration of a flotation.

Simultaneously with the paper version the FSC offers an electronic version of a prospectus, which is then placed on the FSC’s sight in Internet.

The disclosure of information on the flotation of shares and convertible securities of public joint-stock companies should be noted additionally. In its substance this information disclosure takes the form of notifications on all material facts, subject to special procedures. These procedures are regulated by the FSC’s Instruction #9, dated April 20<sup>th</sup>, 1998, on the Sequence and Content of Information Disclosure by Public Joint-Stock Companies on the Flotation of Shares and of Convertible Securities, Offered to Subscribers. Simultaneously the FSC Standards on Flotation were amended by joining the registration of securities and reports on the results of flotation with information disclosure.

The introduction of the above-mentioned Instruction and amendments to the Standards was the FSC's reaction to numerous cases of abuse during the floating of shares and of convertible securities. These multiple cases of abuse stemmed from decisions passed on the board of directors' level on the in-house subscription for shares and convertible securities, which was possible before the introduction of the Federal Law On Protection of Consumer Rights on the Securities' Market. These were at the root of most of the attempts uncovered in practice to "dilute" the capital. Quite often the shareholders did not even suspect that such a decision was passed by the Board of Directors and that a distribution of securities had actually taken place.

In order to provide the shareholders with a chance to know of any accepted decisions and to undertake necessary steps, the FSC established obligatory disclosure of information on a passed decision, on the registration of shares earmarked for flotation, as well as on the completion of floating the securities. The applicable level of such requirements differs, depending on the number of shareholders and on whether a particular company has been included in the list of issuers, whose registration of floating is carried out by the central office of the FSC.

The said Instruction envisages that if shares and convertible securities are floated on the basis of an open subscription, the public joint-stock company is obligated to disclose information practically on each and every stage of the issuing procedure. In accordance with the above Instruction the following information is being published by the Supplement to the Bulletin of the Federal Securities' Commission of the Stock Exchange:

*Report on the Passing of a Decision to Float Securities* (which should include information on the type, form and number of shares earmarked for flotation; the ruling body of the company that passed the decision; the date of its passing; on whether the pre-emptive right is to be exercised by the existing shareholders in the purchase of voting shares and securities convertible into voting stock; as well as time limits and other conditions on the flotation of securities (exclusive of the price of flotation);

*Report on the Official Registration of a Securities Issue* (it should include information on the type, form and number of shares earmarked for flotation; the ruling body of the company that passed the decision; the date of its passing; on whether the pre-emptive right is to be exercised by the existing shareholders in the purchase of voting shares and securities convertible into voting stock; time limits and other conditions on the flotation of securities (exclusive of the price of flotation), as well as information as to the authority which has registered the securities' issue, the date of registration and the serial number of the floated issue and the place(s) where these securities are on sale);

*Report on the termination of the time limit allotted to the flotation of shares, indicated in the registered decision on their issue and in the prospectus; in case all shares have been placed before the lapse of the allotted time, information should be provided on the placing of the last share of the issue* (this information should specify the type, form and the number of floated securities; on the authority which has registered the issue of the securities and the date of the issue's registration and serial number; the date of the actual beginning and the end of a flotation; the factual number of placed securities paid for in roubles, in foreign currencies or other assets; the actual price(es) of floating securities, indicating the number of securities, placed at each price, on the share of the placed securities, as well as information on the completed larger and intended deals with the securities).

When placing shares and convertible securities under a private offering the volume of disclosed information is similar to the information disclosed at a public offering. With a private offering the decision on a flotation and the statement on the registration of an issue is supplemented by information on the participants among whom the securities are expected to be disbursed, and information on the expected larger deals in the distribution of securities, and deals where an interest is shown.

The manner in which the disclosure of information is done under a private placing of shares and convertible securities differs from the manner of the disclosure of information on a securities' placing under a public offering. The requirement of an obligatory publication is narrowed in this case to a notification on the decision

to issue shares, applicable solely to joint-stock companies with 1,000 shareholders or over, as well as to companies, whose issues are registered with the FSC. The rest of the information may be revealed either by entries in the “Supplement to the Bulletin of the Federal Securities’ Commission of the Stock Exchange”, or by notifying the shareholders by mail.

The FSC, while demanding conformity with the volume and sequence on the disclosure of information concerning a subscribed securities’ issue, simultaneously establishes norms aimed at providing the shareholders with a realistic possibility of acquainting themselves with the said information, voice their prejudices on practically any stage of an issue.

Namely, documents submitted for official registration of a public offering of shares and convertible securities of a public joint-stock company, are submitted no earlier than a month after the disclosure of information on a decision on their placing. Documents submitted to the registering authority confirm the fact of having made a public announcement on the passing of the decision on the distribution of securities.

Securities may not be floated earlier than two weeks after the disclosure of information on the registration of an issue of the said securities and of providing all potential investors with the possibility of obtaining information on a securities’ issue, which should be disclosed in accordance with the Federal Law On the Securities’ Market and other official acts of the Federal Securities’ Commission.

The report on the results of a flotation, placed through subscription, is submitted not earlier than two weeks after the disclosure of information on the completion of the distribution. In this case the registering authority is supplied with documents, confirming the disclosure of information on the completion of the securities’ distribution.

Thus any shareholder possesses a realistic possibility to obtain exhaustive information on the issue of shares or convertible securities. If a shareholder believes that as the result of an issue his rights are being or may be violated, he may, not awaiting the completion of the issue’s procedure, to voice his claim by either lodging a complaint with the FSC or choose a court hearing. In practice such proceedings are quite common.

### **Periodic Information Disclosure**

An important step taken in developing the system of information disclosure after the adoption of the Federal Law On the Securities’ Market was the evolution of the issuer’s report into an important periodic source of information for the investor. The Law designates a certain information basis, which should be incorporated into it (broadening it in comparison with the then existing requirements), establishes that the periodic report is to be prepared not in every case, as it was before, but only in cases if at least one issue of securities by the company was accompanied by a registration of a prospectus. Additionally, the Law prescribes for the report to be quarterly.

It was mentioned above that in conformity with the Federal Law On the Securities’ Market, the quarterly report should be disclosed if the registration of at least one of the securities’ issues was accompanied by the registration of a prospectus. Nevertheless the quarterly report may be submitted by the issuer if so desired, which may be explained with a desire to promote a “public” circulation of its securities.

The ideology of the Law and the approach of the FSC towards the establishment of requirements for the preparation of the quarterly report stems from the idea that it, in conjunction with the prospectus, should serve as the basis for forming decisions on whether to invest in securities or sell them. It is for this reason that the quarterly report in its essence and structure is similar to the prospectus.

The format of the quarterly report has been established by the Instruction On the Securities' Issuer Quarterly Report, approved by the FSC's Regulation #31, dated August 11<sup>th</sup>, 1998. It consists of four sections: Section A: Data On the Issuer; Section B: Data On Financial and Operational Activities of the Issuer; Section C: Data On the Issuer's Securities; Section D: Other Data Concerning the Issuer's Securities. (To obtain more detailed information on the requirements governing the contents of quarterly reports of an issuer, other than a credit entity – see Addendum 2).

The Federal Law On the Securities' Market prescribes that the quarterly report on the results of the completed quarter is to be submitted not later than 30 calendar days after its termination. Article 30 of the Law states, that quarterly reports are to be submitted to the FSC or a government office designated by the FSC, as well as to holders of the company's securities at their request for a charge not exceeding overhead costs in printing the brochure. The Instruction on the issuer's quarterly report demands that the issuer of securities, simultaneously with the submission of a printed text of a quarterly report, submits to the FSC its copy on a magnetic carrier. This electronic version of the quarterly report appears on Internet's FSC's sight.

### **Reports On Substantive Facts**

A new step, made by the Law as compared to the preceding acts was the introduction of such a means of information disclosure as reports on substantive facts, influencing financial and business activities of a company. These reports, same as the quarterly reports, should appear if even one issue of securities by a company was accompanied by a registration of its prospectus. Their importance lies in revealing substantive facts in a short timeframe. Nevertheless, similarly to the quarterly reports, reports on substantive facts may be revealed by a company at its discretion.

The companies, in accordance with the Federal Law On Securities' Markets, are to report on the following facts:

- changes in the list of the company's executives;
- changes in the shareholding interests of executives in a company, as well as in its branches or dependent firms, and of participation of the above executives in the capital of other legal entities;
- changes in the list of shareholders;
- changes in the list of institutional investors;
- appearance in the company's register of a major shareholder, possessing over 25 per cent of any type of securities of the company;
- a company's separate or interrelated contracts for a sum total of 10 or more per cent of the company's assets as on the date of the contract;
- facts which have led to a one-time rise or fall in the assets' value of more than 10 per cent;
- facts which have led to a one-time rise or fall in net profit of a company by more than 10 per cent;
- reorganization of a company, it's branches and dependent firms;
- crediting and/or disbursement by a company of remuneration on underlying securities;

- decisions of a company's general meeting of shareholders;
- cancellation of securities;
- information on the dates of completing the register.

Additionally to the above requirements, prescribed by the Federal Law On the Securities' Market, the FSC requests the following additional information:

- on decisions passed by the Board of Directors;
- on the initiation of bankruptcy proceedings towards a company and/or its branch offices or dependent firms;
- on the initiation of court proceedings which may seriously hamper the company's financial standing;
- on contracts where there is evidence of questionable interest.

Companies that had been entered in the FSC's list are expected to disclose information on changes in the shareholders' register on members of the board possessing 5 or more per cent of voting stock.

In accordance with Article 23 of the Federal Law On the Securities' Market, "all reports of substantive facts, bearing on financial and business interests of a company should be reported by the company under the information disclosure title to the registering office in order to provide accessibility in accordance with Article 30 of the Federal Law within five days of the appearance of the fact». Article 30 of the above Law supplements this requirement by a demand to make such information public by publishing it in mass media with a circulation sufficient to supply the better part of holders of the company's securities.

In accordance with the Instruction on the Disclosure of Information on Material Facts (Events, Proceedings), Having Effect Upon the Financial and Business Activity of the Issuer of Securities, reports on substantive facts should be published in the Supplement to the Bulletin of the Federal Securities' Commission of the Stock Exchange, it being the official publication of the FSC. Similarly to the prospectuses and the quarterly reports, the Instruction requests the submission of an electronic version of the substantive facts report to the FSC in order to have it accessible on the FSC's Internet sight.

### **The Role of the Federal Law on the Protection of Rights and of Legal Interests of Investors on the Securities' Market in Regulating the Disclosure of Information**

The Federal Law on the Protection of Rights and of Legal Interests of Investors on the Securities' Market entered into force in March 1999. This law established important norms, pertaining to information disclosure.

The Law establishes rules on the disclosure of information by professional members of the stock exchange market on the circulation of securities. Article 6 of this law stipulates that whenever an investor purchases securities through a professional member of the stock exchange, or when the latter acquires securities in the name of an investor, the professional member when requested by the investor is obligated to furnish him with information contained in the decision to emit these securities and in the prospectus. Thus this law furthered the substance of Article 30 of the Federal Law on the Securities' Market which stipulated that professional members of the securities' market "when offering and/or announcing the buy/sell prices of securities must

disclose the generally available information offered by the issuer of these securities, or to establish the fact that he is not in possession of such information.

Apart from that, the Federal Law on the Protection of Rights and of Legal Interests of Investors on the Securities' Market established supplementary sanctions in cases of violation of the requirements on the furnishing of information envisaged by that law and by other legal acts. Thanks to this law the investor obtained the right to demand an alteration or even an annulment of his contract with the issuer or with the professional member of the securities' market.

Another important rule, established by the Federal Law on the Protection of Rights and of Legal Interests of Investors on the Securities' Market, is found in Article 4. This article establishes a limitation on the circulation of securities of issuers who fail to disclose information to the extent and sequence which are prescribed by legal acts of the Russian Federation on securities with a public offering. Such limitations include a ban on advertising of these securities or to offer them to an unlimited circle of investors. Thus if issuers, whose placing of securities has not been followed up by a registration of the prospectus, wish to have their securities traded on the organized market, should disclose the information in the form of quarterly reports and as reports on substantive facts. The importance of this article rests with the fact that it eliminated the deficiency of the Federal Law on the Securities' Market which, while linking the requirement for the disclosure of quarterly reports and reports on substantive facts with the registration of the prospectus, nevertheless failed to limit the possibility of a public offering of securities if the prospectus had not been registered. Prior to the enactment of this law, the securities of an issuer, despite the fact that none of their issues were followed up by the registration of the prospectus (whether owing to negligible nominal values or unimportant number of subscribers) could circulate on the organized market without disclosing information.

Article 5 of the Law established personal responsibility of those, who signed the prospectus, for any damages inflicted upon investors as a result of doubtful or misleading information contained in the prospectus. Until now the Russian law had not established any responsibility of the company's executives for inadequate information. With the passing of the law the executives of an issuer who signed the prospectus, as well as the evaluators and auditors, who substantiated the information contained within, share a "collective subsidiary responsibility" with the issuer.

Lastly, the law envisages administrative responsibility in the form of a penalty for: advertising securities which have not been registered and for offering them to an unlimited range of investors; securities, whose issuer does not disclose information, prescribed for securities earmarked for public offering; and also for violating the rules on the disclosure of information (Article 12).

It should be noted that prior to the passing of the Federal Law on the Protection of Rights and of Legal Interests of Investors on the Securities' Market the Russian law had no provisions regarding responsibility and thus no single registering office could realistically enforce the regulations on the disclosure of information.

### **III Situation with Information Disclosure. Drawbacks in the Existing Procedures Regulating the Disclosure of Information on Securities**

The formation of a system on information disclosure in Russia takes place with a harsh backdrop of struggle for corporate control. The role of the FSC in this fight is determined primarily by its role of an authority, registering the issue of securities.

The obligatory registration of all new issues, which provided the FSC with the possibility to control adherence to requirements addressed not only to public, but also to private offerings, is considered as an obligation of the FSC to do the job. The task of protecting the interests of the investors does not allow the FSC to limit its activities to a sole function of a registering office, i.e. to check the fullness of information passed on to the investor. Up to now the offering of securities was accompanied by a multitude of violations, which on the one hand materially infringed upon the interests of the existing investors, first of all of the shareholders, while on the other hand the rights of new investors were rather dubious. Before the situation improves the FSC will not be in a position to stop controlling the issuing procedures.

At times violations may be detected during the registering of the securities (1). Such was the case with the private (OAO) Siberian Oil Company (2), whose prospectus on the shares did not correspond to the decision on the issue and contained information which could mislead the investors. Another example was with OAO "Sidanko", which submitted documents that showed that there was no required decision at all on the issuing of shares. In some cases, as for example with OAO "Tambovenergo" or OAO "Dalmoryeproduct" registration of emission of shares was precluded by a breach of the responsibility to present a quarterly report.

Non the less practice shows that by far not all infringements can be traced at the stage of registering the securities. In most cases the violations, which may have been sufficient to refuse registration of securities, were uncovered by the investors, whose interests were affected. But it is often that cases on the breach of registration procedures were brought to the attention of the FSC only after their registration has been completed or, moreover, even after the securities had already been placed.

The Federal Law on the Securities' Market stipulates that the annulment of an issue of already registered securities is possible in two ways: it can be proclaimed as not having taken place or void.

In contrast to proclaiming the issue void, which can only be established in court, an issue may be proclaimed as not having taken place if drawbacks in the issuing procedure are uncovered prior to the registration of a report on the results of the offering. In this case the registering office refuses to register the report on the results of the offering. In practice this has become the most efficient means of protecting the interests of the investors (3).

The FSC has chosen precisely this latter method in a number of cases. As an example the case of the refusal to register the report on the results of an issue by OAO "Nosta" may be mentioned.

With the enactment of the Federal Law on the Protection of Rights and of Legal Interests on the Securities' Market, the FSC obtained the possibility to prosecute for the breach of rules on the disclosure of information. The law offers the FSC the right to levy fines upon the executives to amounts up to 200 minimal wage levels, while legal entities may be fined up to 10,000 minimal wage levels. These measures closely correspond to the character of violations, related to the disclosure of information.

One of the faults of the existing regulations pertaining to the disclosure of information is the fact that the information disclosure, which should be carried out by issuers in accordance with the Federal Law on the Securities' Market, is in some respect useless.

Analysing the acting Federal Law on the Securities' Market it should be pointed out that on the one hand it simplified registration of securities (it no longer needs to be accompanied by the registration of a prospectus if the number of investors or the amount of money attracted by the new issue of a similar type of securities together with the previous issues surpasses a certain amount). On the other hand, the Law does not contain a provision, similar to the provision of Decree #78, stating that the registering authority has the right to waive the registration of the prospectus on privately offered issues. On top of that, demands for the registration of a prospectus in a private offering, as prescribed by law itself (on sums of nominal value of issues and on numbers of investors), is rather ineffectual.

Firstly, the Law does not consider the method of an issue, which forces to register a prospectus not solely when subscribing to an issue, but also during the distribution of extra shares among the shareholders, with an increase in the nominal value of shares, and with a change of rights allocated to various shares. Secondly, at subscription time the Law ignores the composition of investors participating in the subscription. Thus, registration of a prospectus is required even when shares with a nominal value in excess of 50 thousand minimal wage levels are subscribed to by a sole professional member of the securities' market.

It is evident that the registration of a prospectus is required only when additional investments are attracted, i.e. when placing securities through a subscription. Registration of a prospectus is by far not a necessity in all cases of subscription. Registration of a prospectus should be waived in cases when the list of participants is such, so as to allow for the presumption of them being well informed on the state of affairs of the issuing company (an investment bank, a commercial bank, the issuing company's own directors etc.).

The existing rules are perceived as senseless and thus cause hostility on the part of the issuers. Additionally, these demands confuse the issuer as to the purpose of a prospectus as an instrument of information disclosure, hamper the issuing process and increase costs of its implementation.

A different problem is linked with quarterly reports and reports on substantive facts. If an issuer can not avoid registration of a prospectus under threat of all his transactions with securities deemed void, he may abstain from furnishing regular information. This, as was expected, became a major hindrance in the disclosure of information. Data obtained from the FSC shows that quarterly reports and reports on substantive facts are not submitted in proper way by an overwhelming majority of issuers who are obliged to do so (4).

Partially this may find an explanation in the fact that prior to the entry into force of the Federal Law on the Protection of Rights and Legal Interests of Investors on the Securities' Market, the registering authorities had no means to punish wrongdoers who avoided this duty.

But there are other reasons that have a stronger impact upon the motivation of the issuers to disclose or not to disclose information.

As was mentioned before, in a number of cases there is no necessity in registering the prospectus. Considering that the responsibility for the preparation of quarterly reports and reports on substantive facts is linked by law expressly with the registration of a prospectus, it follows that the issuer, which has registered the prospectus, shall hence be responsible to disclose information in the form of quarterly reports and reports on substantive facts. In cases where this responsibility is shouldered by issuers, whose securities do not circulate or circulate in negligible volumes on the securities' market (in a company where all shares belong to a single proprietor) the above requirement is senseless. The need to conform with this demand meets with resentment as it requires even higher expenses than with the drafting of a prospectus, which, in turn, are also not called for.

It should be noted that in the conditions of the financial crisis all demands as to the disclosure of information are looked upon as a burden.

Competition for investments could stimulate the companies to furnish information. But no Russian issuer is at present competing for investments. The FSC's experience shows that the majority of share offerings have no connection with the attraction of new investments (5).

Under the conditions of an adverse business climate non-disclosure of information appears to be a common reaction on the part of the owners. Requirements on the revelation of information is considered as another attempt of the government to pry into the real financial position of a company.

With this in mind it can be understood, that the information, offered by companies, is distrusted by outsiders. No one looks upon this information as having any more truthfulness than any other information that reaches the market.

The presently existing draft proposals on changes in the Federal Law on the Securities' Market, in which the FSC's active hand is evident, contains a number of amendments which should eliminate senseless cases of information disclosure, introduce a more orderly submission, limited to cases where it is realistically required. As a result, it is expected that its role shall be better understood by issuers and investors.

Simultaneously with the lifting of the necessity to disclose information in cases where it is not called for by necessities, it becomes important to raise the quality of the submitted information.

Primarily this concerns financial reporting. A major problem with the presently revealed financial information is its non-comparability with reports for various periods of time. On the whole the explanation lies in the swift changes which are being introduced in the last few years into the bookkeeping system. But from the point of view of consumers of financial reporting, real comparability of reported data constitutes the essence for their analysis and for making decisions on investing, crediting, etc.

Another problem is linked with the usefulness of the submitted financial information (6). The traditional trait of Russia's bookkeeping was its orientation on taxation. Rules established by the government on bookkeeping and reporting centered primarily upon making it a base for the calculation and payment of taxes. Although today the bookkeeping reports should not be classified as being oriented solely on taxation, in certain aspects this is still true. Such information is useless for the investor and breeds distrust. Quite often the companies proper realize that their financial returns are misleading for the investor and does not provide him with a true picture of the company's financial situation. Non the less, the introduction of specific reporting rules for the disclosure of information seems problematic. The first reason is that it calls for a dual system of bookkeeping, which is expensive and difficult to implement owing to a lack of specialists, and secondly it is hard to expect truthful reporting if it results in increased tax payments for the company as compared with the traditional files.

It is important to clearly separate the principles of preparing and submitting reports for tax and financial purposes, otherwise tax and financial aims will be confused while being not only different, but oftentimes quite in opposition to each other. In this connection the process of reforming Russia's bookkeeping procedures to put them in line with internationally accepted practices is of utmost importance, as this will offer the user precisely the needed financial information on a company. Adequate financial information may be obtained only from an adequate bookkeeping reporting as a whole.

The FSC lends an active hand in the transformation of the bookkeeping standards. Thus, the Commission is actively engaged in developing drafts of the Russian standards on financial inputs and earnings per share. The FSC participates in the work of the Interdepartmental Commission on Bookkeeping Reform and Financial Reporting.

Much attention is paid to the legibility of the submitted information. It is important that it satisfies both the inexperienced investor and the financial analyst.

Evidently, the existing present day structures of the prospectus and of the quarterly report are not quite up to par. The step aimed at the expansion of information disclosed by the issuers was substantive, nevertheless the next step should bring an improvement of its form.

Lastly, methods of furnishing information should also be improved. First of all this refers to information disclosure through electronic means. At present the issuer is required to furnish the information earmarked for disclosure to the FSC on a diskette. Then this information opens up on an Internet site. Up to now it is considered to be the best way to protect information from unauthorized access. Simultaneously this offers a means of controlling periodic disclosures of information by the FSC. Nevertheless such a procedure visibly hampers information disclosure and creates a number of legal problems. Firstly, should the FSC control the volume of information which is being offered for disclosure on a surrendered diskette, and secondly, does the FSC assume responsibility for discrepancies in the information disclosed on its site and that presented by an issuer on its diskette.

In order to facilitate the procedure of information disclosure it is necessary to allow issuers to divulge information to Internet on its own with a condition that such information is being disclosed in a definite place, known to all investors and preferably in the same place with other issuers, who similarly disclose their information. In this case the responsibility for the volume of information rests with the issuer which discloses the information. A certain hindrance in this respect and the basics for the existing procedure of information disclosure is found in the Federal Law On the Securities Market, which envisages that within the scope of information, disclosing substantive facts, the latter should expressly be submitted to the FSC (or another registering body) in order to provide access to it.

Presently the FSC is considering the possibility of information disclosure in an electronic form under the surveillance of the self-regulatory organization of the professional members of the stock exchange.

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## **Addendum 1**

### **Requirements on the Content of Prospectuses of Issuers Other than Credit Entities**

#### **Part A. General Information on the Issuing Company**

This section prescribes the following requirements:

- name of the company;
- information on the company's national registration;
- information on the economic sector of the company' activities;
- information on the company's postal address and contact telephones;
- information on partners (if a joint-stock company is being established – on all shareholders, but when additional shares or bonds are being issued – on those who possess over 5 per cent of the share capital, as well as on investors, having no less than a 20 per cent stake in a company's share capital;
- description of the company's administrative structure;
- information on the company's board of directors (supervisory council) (names, dates of birth, directors' functions for the last 5 years, indicating spheres of activities, and shares in the capital of the company, it's branches and dependent companies;
- information on the companies' single owner's (proprietor's) or collective executive body (name of the proprietor acting as the executive body, names of members of the collective executive body, their dates of birth, functions for the last 5 years, indicating spheres of activities, as well as shares in the capital of the company, its branches and dependent companies);
- information on all types of remuneration paid to members of the board, members of the executive body and to other executives of the company;

- information on legal entities in which the company has a stake of over 5 per cent, and the share of the said entities in the company's share capital;
- information on other legal entities affiliated with the company, including those possessing in excess of 5 per cent of voting shares at the company's general meetings;
- information on the participation of the company in industrial, banking, financial groups, holdings, concerns and associations;
- information on the company's branch and representative offices;
- information in respect of the company's number of employees;
- history of the company's incorporation and activities;
- company's plans of future development;
- principle commodities or services (mentioning those whose output during the last three fiscal years has been contributing over 10 per cent to the company's annual sales, showing all types of exports of goods and services);
- description of the company's principle activities;
- sources of raw materials, commodities and services (indicating the company's suppliers contributing over 10 per cent of all deliveries with an indication of future perspectives as to the availability of the said supplies in the future);
- markets for the company's product (goods, services, indicating buyers with over 10 per cent of the company's sales of goods or services, indicating possible negative factors, capable of influencing the company's deliveries of goods and services);
- the company's policy towards inventories (showing the company's policy as to its current assets and inventories, including the inventory turnover ratio and methods of its determination);
- seasonal effects upon operations (showing which processes are seasonal and their share of the overall sales);
- outstanding liabilities (showing any of the company's sizable future commitments and the negative consequences which these liabilities are prone to influence the company's activities);
- principal competitors (indicating the company's competitive environment, including concrete markets where the company conducts or plans to conduct its activities, principal present and potential company's competitors);
- important contracts and company's obligations (noting every deal that has to be fulfilled or completed in the course of the next six months starting from the date of passing the decision on the issue of the securities, if the amount of such a deal (deals) exceeds 10 per cent of the book value of the company's assets);
- description of the risk factors (with a detailed analysis of the risk factors affecting the owners of the securities, subdivided into the following groups: economic, social, technical, ecological);

- additional relevant information (outlining other information pertaining to the company's activities, which may influence future purchases of company's securities).

Standards contain specifics in reference to Part A of the prospectuses on share issues by investment funds. Apart from other information they should include an investment declaration and data on a specialized depository.

### **Part B. Data on the Company's Financial Status**

This section embraces financial records of a company for the last three fiscal years, the balance sheet for the last quarter, information regarding the government share in the company's nominal capital, data on the called capital as outlined in the company's articles of association.

### **Part C. Information on Previous Securities' Issues**

This section contains information on all registered securities (including securities, whose issue was judged as either not having taken place or void) namely:

- rights, accorded with the possession of the securities;
- methods of their flotation;
- body, which carried out their registration, as well as the registration of the report on their issue;
- main markets where these securities circulate.

### **Part D. Information on New Issues**

This section indicates:

- the number of securities earmarked for flotation;
- rights accorded to investors of the securities;
- method, term and sequence of their flotation;
- price of flotation, conditions and sequence of payment;
- information on the passing of the decision on the flotation of securities (the body which passed the decision on flotation, date of decision);

- description of secured bonds;
- information on underwriters;
- information on the expected use of funds obtained from flotation, taxation of the income, derived from the flotation.

### **Part E. Additional Information**

This section deals with:

- limitations in the circulation of securities;
- other specifics regarding flotation and/or circulation of securities.

### **Addendum 2**

#### **Requirements Governing the Contents of Quarterly Reports of an Issuer, Other than a Credit Entity**

##### **Section A. Data On the Issuer**

The present Section should contain general information on the issuer. Basically Section A of the quarterly report is similar to Part A of the prospectus. It should contain:

- name of the issuing company;
- information on the company's national registration;
- information on the economic sector of the company' activities;
- information on the company's postal address and contact telephones;
- information on the auditor;
- information on organizations keeping records on the rights to the issuer's securities (indicating the registrar and, if the securities are in a centralized depository, the depository);
- information on participants (reports from companies which had floated securities through a public subscription, and companies, which have been listed by the FSC (7); information on investors possessing no less than 5 per cent of the issuer's share capital, as well as on investors of the same issuer, having no less than a 25 per cent stake in the company's share capital; reports of other issuers should include information on shareholders with no less than a 20% share in the company's capital;
- description of the company's administrative structure;

- information on the company's board of directors (supervisory council) (names, dates of birth, each of their functions for the last 5 years, indicating spheres of activities, and shares in the capital of the company, its branches and dependent companies);
- information on the companies' single proprietor or collective executive body (name of the single proprietor in the capacity of the executive body, names of members of the collective executive body, dates of birth, their functions for the last 5 years, indicating spheres of activities, as well as shares in the capital of the company, its branches and dependent companies);
- information on all types of remuneration paid to members of the board, members of the executive body and to other executives of the company;
- information on legal entities in which the company has a stake (in the reports of those issuers, which have floated securities on a public subscription, as well as of those, which are listed by the FSC, information should be provided on legal entities where the issuer possesses at least 5 per cent of the share capital, while in the reports of other issuers information is included on legal entities in which the issuer possesses no less than 20 per cent of their share capital);
- information on other legal entities affiliated with the company, including those possessing in excess of 5 per cent of voting shares at the company's general meetings;
- information on the participation of the company in industrial, banking, financial groups, holdings, concerns and associations;
- information on the company's branches and representative offices;
- information in respect of the company's number of employees;
- description of the company's principal activities;
- description of the general state of the chosen sector of the economy;
- description of the company's principal activities and of their share in overall sales;
- sources of raw materials, commodities and services (naming the company's suppliers contributing over 10 per cent of all deliveries with an indication of future perspectives as to the availability of the said supplies in the future);
- principle markets for the company's product (goods, services), (listing buyers with over 10 per cent of the company's sales of goods or services, indicating, possible negative factors, capable of influencing the company's deliveries of goods and services);
- the company's policy towards inventories (showing the company's policy as to its current assets and inventories, including the inventory turnover ratio and methods of its determination);
- seasonal effects upon operations (showing which processes are seasonal and their share of the overall sales);
- principal competitors (indicating the company's competitive environment, including concrete markets where the company conducts or plans to conduct its activities, principal present and potential company's competitors);

- company's plans of future development;
- information on the company's share capital;
- information as to the government's share in the share capital and of any special rights;
- information on issued shares;
- existing contracts and company's obligations (noting every deal that has to be fulfilled or completed in the course of the next six months commencing with the date of passing the decision on the issue of securities, if the amount of such a deal (deals) exceeds 10 per cent of the book value of the company's assets);
- company's liabilities regarding flotations of shares and convertible securities;
- important happenings of the last quarter;
- information on the company's reorganization, of its branches and dependent companies;
- additional substantive information (outlining other information relevant to the company's activities, which may influence the marketability of the company's securities).

The present section of the quarterly reports, filed by investment funds, should also contain an investment declaration as well as information on a specialized depository.

### **Section B. Data On Financial and Operational Activities of the Issuer**

The present section embraces the company's annual reports for the last three fiscal years, a balance sheet for the last quarter, information as to the government's share in the issuer's share capital, information on called capital as laid down in the company's articles of association.

Also included are: facts contributing to an increase or a decrease in a firm's assets by over 10 per cent during one quarter; facts responsible for an over 20 per cent change in the profit & loss results occurring within the last quarter's timeframe; the last quarter's company's contracts for sums in excess of 10 per cent of the company's assets as compared with figures for the previous quarter; data on the utilization of funds obtained as a result of placing securities.

### **Section C. Data On the Issuer's Securities**

This section carries description on all registered securities (including securities whose issue had been proclaimed as not having taken place or void):

- rights, allocated with the securities;

- placement methods;
- registering authority, as well as the registration of the report on the results of their issue;
- principle markets, dealing in the above securities.

Information on bonds is supplemented by yield in the last quarter.

#### **Section D. Other Data Concerning the Issuer's Securities**

This section covers:

- dividends approved and paid out by the company during the last three years;
- limitations in the circulation of securities.

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#### **References:**

- 1) According to the FSC's 1998 Annual Report 2,612 issues of securities were refused registration in 1998, which accounts for 13 per cent of the total number of issues, submitted for registration
- 2) This and other examples are quoted from the FSC's Annual Report for 1998.
- 3) According to the FSC's 1998 Annual Report 1,102 reports on the results of issues were refused registration in 1998, accounting for 6 per cent of the total.
- 4) Approximate data furnished by the FSC reveals that for the date of submission of quarterly reports for the 4<sup>th</sup> quarter of 1998 in most regions of Russia no more than 10 per cent of issuers, who are obligated to file their quarterly reports, actually did so in time.
- 5) According to the FSC's Annual Report for 1998, during that year 19,848 share issues and 93 issues of bonds were registered. Out of the 73 issues of shares, registered with the FSC's central office, only 7 issues underwent subscription. The rest were connected with capitalization, consolidation and stock splits, with an increase or a decrease of their nominal value and other operations.
- 6) This is not relevant of Russian issuers disclosing information in accordance with international or foreign standards in order to secure circulation of their securities as well as ADRs and GDRs abroad.
- 7) The legal acts of the FSC specify companies whose issues of securities was registered by the FSC's central office. These issuers are grouped in a special file which is formed according to the importance of the securities for the Russian securities' market (at present there are 498 entries).

Перевод роо

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