MARCH 2012 TECHNICAL SEMINAR BACKGROUND PAPER

Oleg Shvyrkov, Ph.D.¹

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The purpose of this report is to present background information to participants of a technical seminar of the OECD Russia Corporate Governance Roundtable organized for March 2012 in Moscow, Russian Federation. The paper addressed three issues: i) Building on the earlier research by the OECD, this paper presents an overview of the traditional role of stock exchanges in setting and enforcing corporate governance standards in various markets, as well as the current role of exchanges in corporate governance regulation in Russia; ii) Building on the earlier research by the OECD, this paper presents an overview of the existing disclosure regulations in Russia and the role of listing rules in transparency of Russian public companies. It also draws some international comparisons and outlines several areas for improvement in transparency that could potentially be achieved through listing rules; and iii) Building on the earlier research by the OECD and IOSCO, this paper presents an overview of regulations on insider trading and market manipulation in Russia and draws some international comparisons.

¹ Oleg Shvyrkov is a Director for Corporate Governance at Deloitte CIS, based in Moscow. This report has been completed as an individual consulting engagement and may not reflect the views of Deloitte or the OECD.
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THE ROLE OF A STOCK EXCHANGE IN SETTING CORPORATE GOVERNANCE STANDARDS

1. Executive summary

1. The inflow of portfolio investment in the emerging economies in the first decade of the 21st century significantly increased the role of the international equity markets as a source of funding for companies worldwide. This fostered the development of the ‘equity culture’ in the markets previously focused on the role of business groups as a source of funding and made the regional and global exchanges more impactful in shaping the governance environments of the national markets. The role of exchanges in the formulation and enforcement of corporate governance-related rules varies widely and has been rapidly evolving over the past two decades.

2. Amidst concerns that the increasing global competition between exchanges may cause a regulatory ‘race to the bottom’, the potential role and incentives of exchanges have been put in question by various regulatory agencies and academics. An opposing view, often voiced by exchanges, points to the fact that no exchange has been served well by weak governance regulation – or investors’ distrust in general. Several empirical studies and practical examples presented in this report (such as the success BOVESPA’s premium segments) tend to support the latter view.

3. This report provides an overview of specifics strategies and policies with respect to regulation of corporate governance adopted by various exchanges. Several potentially relevant observations result from this analysis. The choice of structures that provide the monitoring/compliance role is important, for example, and arrangements that provide the exchange’s regulatory arm with sufficient autonomy and resources tend to be the most potent. Successful examples involved creation of a separate legal entity with its own budget or when the monitoring activity is delegated to a self-regulatory organization.

4. Further, the exchange’s proactive role in standard-setting is usually beneficial for financial markets. Exchanges are increasingly active, and in many cases, act as a driving force for governance regulation. This does not mean that exchanges are likely to succeed in acting unilaterally, though: involvement of international portfolio investors in the development of listing rules or guidelines for issuers is very important. These stakeholders have the most relevant perspective of risks and regulatory voids in the legal environment.

5. The specific approaches to implementation of corporate governance norms differ substantially between markets. The comply-or-explain approach, pioneered in the UK and adopted in a substantial number of countries, worked reasonably well in some markets, but did not have a universally satisfactory effect. Countries accustomed to ‘hard law’ appear to be relatively less receptive to this approach. The opt-in system offered by voluntary ‘strong governance’ segments, on the other hand, represents another potent tool, yet its effectiveness depends on the smart choice of listing criteria and credibility of issuers’ commitments to them. In other words, the criteria must address the primary governance risks, and issuers should not be allowed to abandon their listing segments (and associated obligations) at will.

6. Finally, this report notes that Russian exchanges have so far played a generally less active role in governance regulation than many peers, despite the presence of significant weaknesses in legal environment, current regulatory practices, and the prevailing view of Russia as a market with very significant governance risks. Although there are signs that things might be starting to change, there is still no premium segment that issuers could choose to signal their strong governance standards credibly. Many
companies choose to do so through foreign listings. At the same time, a light version of a ‘comply-or-explain’ policy has been in place for about a decade, yet it has not produced any tangible benefits.

2. The Role of Exchanges in National Governance Infrastructures: an Overview

Traditional Role of Exchanges in Corporate Governance Regulation

7. In the US and the UK, exchanges played a significant role in promoting corporate governance standards already in the beginning of the 20\textsuperscript{th} century (Coffee, 2001). And yet the debate on motivation and ability of stock exchanges to regulate governance standards is very much alive today, largely driven by concerns that an increasing global competition in financial markets, and the spread of alternative trading platforms may lead to a regulatory ‘race to the bottom’.

8. Several policy-makers and academics argued, for example, that the passing of Sarbanes-Oxley (SOX) Act in 2002 undermined the competitiveness of US exchanges; the increased listing activity on the London Stock Exchange is often cited as a proof of its damaging effect.

9. In fact, there is nothing new about competition between exchanges: NYSE, for example, has emerged as survivor in competitive struggle that wiped over one hundred of regional exchanges at the turn of the 20\textsuperscript{th} century in the US. Formerly overshadowed by Boston’s exchange in equity trades, NYSE came to the forth as the world’s leading stock exchange not least because it took the most consistent stance in terms of corporate disclosure and governance standards. In viewing itself as investors’ guardian, NYSE refused to list issuers of non-voting shares since 1926, under its famous ‘one share–one vote’ listing rule (Coffee, 2001). Remarkably, 75 years later, the Brazilian BOVESPA was able to hold its ground against the NYSE by using the same tactic: it introduced the ‘one share – one vote’ principle in its premium listing rules and developed other criteria that exceeded NYSEs disclosure and governance requirements to foreign issuers.

10. Indeed, ‘strong governance’ listing regimes are not automatically successful. Despite its rapid initial expansion, Germany’s Neuer Markt was eventually crippled by adverse economic trends and several weaknesses of the legal environment that were beyond the exchange’s control (Coffee, 2002). There have also been cases of commercially successful unregulated markets that made equity capital accessible to fast-growing small firms (e.g. LSE’s AIM and Warsaw’s ‘New Connect’ markets). There is overwhelming evidence, however, that in the long term, strong regulatory regimes tend to benefit financial markets: about 70\% of all foreign listings took place in the US and UK over the past two decades. While the US and UK exchanges accounted for about 40\% of all foreign listings in the 80s, their share has gone up to 60\% by 2006 (Fernandes & Giannetti, 2009).

11. Several academic papers analyzed the listing patterns in the US and UK before and after the introduction of Sarbanes-Oxley regulation in the US. Fernandes and Giannetti (2009) concluded that, on average, SOX made no effect on issuers’ propensity to list in the US, although this effect may not have been the same for small and large firms. Similarly, Doidge, Karolyi, & Stulz (2009) found that the increase of listing activity on the London Stock Exchange relative to the US exchanges reflects solely the rise of the unregulated AIM market. By and large, the AIM segment attracted mainly the domestic UK issuers too small to benefit from a US listing.

12. The US which has so far resisted the creation of unregulated segments and the potential consequences of such markets for the financial system remain a hotly debated topic today. In addressing the Congress in September 2011, President Barack Obama called to lift the ceiling on mini-offerings providing exemptions from disclosure and anti-fraud regulations, from 5 million to 50 million US dollars. This initiative, currently with the Congress, drew fire from prominent academics and policy-makers who
expressed concerns that it may expose unsophisticated investors to corporate fraud and have a detrimental overall effect on financial markets.

Figure 1. New listings in the US and the UK, 2001-2011.

![Graph showing new listings in the US and the UK, 2001-2011.](image)

Sources: World Federation of Exchanges, NASDAQ IPO & SPO statistics, LSE statistics.

13. Figures 1 and 2 illustrate the dynamics in new listings and capital raised in IPOs/SPOs on the NYSE Euronext’s US platforms, NASDAQ, as well as LSE’s AIM segment and the Main market. These graphs cover the period from 2001 until 2011 and include five to six years of data that was not included in the research cited above. In line with these researchers’ conclusions, the graphs show a spike in the AIM’s listings in 2004-2007. However, 10 years into SOX regulation, the US listing dynamics do not appear to have particularly suffered in relation to LSE’s main floor.

Figure 2. Capital raised in IPOs and SPOs in the US and the UK, 2001-2011. Figures in USD million.

![Graph showing capital raised in IPOs and SPOs in the US and the UK, 2001-2011.](image)

Sources: World Federation of Exchanges, NASDAQ IPO & SPO statistics, LSE statistics.

14. The second graph shows a significant spike in volumes of capital raised on the LSE’s main floor between 2006 and 2009, followed by a sharp drop in 2010. Although the exact mechanisms that led to this hump are beyond the scope of this paper, I note that, occurring five years after the adoption of SOX and
subsequently levelling off, this spike is unlikely to reflect the tightened US regulation. Economic patterns in nearby time zones (such as the sporadic activity of large Russian issuers) appear to present a more intuitive explanation.

15. To summarize, one can safely presume that weak governance regulation has served no market well in the past. Not without controversy in themselves, unregulated segments flourished only in those geographies where they acted as alternatives and complements to strong traditional markets. In the emerging world, the most effective strategy to develop regional financial markets has so far been to match and exceed the level of investor protection offered by the global financial centres, as shown by several Latin American markets.

*Forms and practices of exchanges’ involvement in governance regulation*

16. Earlier research by the OECD (Amico & Christiansen, 2009), cited in the Box below, presents an overview of specific forms and roles that the exchanges play in the development, formulation, and surveillance of governance requirements.

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**Box 1. Previous OECD work on the subject**

The regulatory function of stock exchanges was in the past mostly limited to issuing rules and clarifying aspects of existing frameworks. The standard-setting role of stock exchanges was essentially exercised through the issuance of listing, ongoing disclosure, maintenance and de-listing requirements. On the enforcement side, stock exchanges have shared their regulatory function with capital market supervisory agencies. In addition to overseeing their own rules, stock exchanges were assigned the role of monitoring the compliance with legislation and subsidiary securities regulation. Since the promulgation of the OECD Principles of Corporate Governance, stock exchanges have often enlarged their regulatory role to embrace a wider palette of corporate governance concerns. They have contributed to the development of corporate governance recommendations and encouraged their application to listed companies. [...] 

*A self regulatory tradition in North America…*

In North America, certain regulatory functions of exchanges have been delegated or contracted to third party non-governmental regulators (FINRA in the United States and IROC in Canada), while others, notably in the area of listing, have been retained by exchanges themselves. In Europe, in most cases, it is the capital market regulators, not exchanges, who have an upper hand in issuer regulation according to national and, in many cases, EU legislation. For instance, in Poland, the company is required to submit a draft of the issue prospectus to the Polish Financial Supervision Authority, which has the authority of approving it (or not), even before the company submits an application for the admission of shares to the WSE Management Board.

The responsibility for company listing in many other OECD member countries is shared between the stock exchange and the securities regulators. In France, for instance, while it is the Board of Directors of Euronext Paris that decides on the admission of financial instruments on its market, it consults with the Autorité des Marchés Financiers and seeks its observations before listing. Likewise, in Australia, the responsibility for listed companies’ compliance with listing rules is shared between the ASX and the Australian Securities and Investments Commission (ASIC). In jurisdictions with more extensive self regulation, listing authority tends to be delegated to exchanges. For example, in the United States, the decision to list a particular issuer is made by the exchange. In addition, an issuer must comply with all SEC requirements applicable to listed companies.

**Monitoring is mostly a shared responsibility**

Monitoring of ongoing disclosure requirements is also not typically the sole purview of exchanges. Given that at least some aspects of disclosure regimes are not based on stock exchange rules but on legislation or regulatory authority rules (i.e., in the area of takeovers or accounting standards), exchanges may have a minor role in enforcing non-compliance. More often than not, the thrust of exchanges’ responsibility in the enforcement function lies in their capacity to monitor market developments and bring cases to the attention of securities regulators. Hence, exchanges can obviously make an important contribution to the prevention of fraud and other abusive practices. Exchanges are usually committed to report breaches of market integrity or disclosure rules by virtue of memorandums of
understanding with market regulators or subject to similar statutory or regulatory obligations.

[...] A variety of measures were implemented to safeguard exchanges regulatory role, aimed at ensuring that exchange regulation is subject to appropriate incentives, checks and balances. A key mechanism introduced by several exchanges is the separation of exchanges’ profit making and regulatory functions. For instance, in connection with the demutualisation and self-listing of NYSE, NYSE Regulation – a non-profit subsidiary of NYSE – became responsible for market surveillance and enforcement of rules that relate to trading on NYSE and through a regulatory services agreement, provided oversight for NYSE Arca regulation. The OMX Nordic Exchanges have also established a separate structure (though not an independent legal entity) responsible for monitoring issues related to self-listing and market surveillance. Reporting relationships have evolved to reflect these new structures. At the beginning of 2009, the Six Group - of which the Six Swiss Exchange is a part - has separated the firm’s regulatory functions from operational activities. Going forward, rule-making will be the task of the Regulatory Board, whereas enforcement of rules will be conducted by the SIX Swiss Exchange Regulation Unit (a new structure to address issuer regulations and supervise securities trading).

**Demutualisation of exchanges gave rise to concerns about their self-regulatory capabilities**

Academic literature has raised questions about the effectiveness of such arrangements, pointing out that a "regulatory arm" of an exchange can be financed through the budget of the profit making entity. Unless the budget of the regulatory arm is both independent and substantial, the number of instances that it can investigate may arguably be insufficient (Brown, 2008). The importance of further insulating the regulatory entities which are part of exchange groups has therefore been repeatedly stressed in public debate. Entities such as FINRA, which performs market regulation under contract from several large American exchanges, has been highlighted by some as representing a good practice in this respect. Insulation of the regulatory function from exchanges via segregation or outright outsourcing, coupled with the fact that these regulatory powers are circumscribed by existing regulation/legislation (and in some instances subject to approval from other regulatory agencies), puts the regulatory function of exchanges in context.

**Corporate governance codes and recommendations for listed companies**

Following the adoption of the path-breaking Cadbury Code in the United Kingdom in 1992 national corporate governance codes have proliferated. [...] As mentioned earlier, whilst not initially in the driving seat, stock exchanges – in some cases alongside with capital market regulators and investor organisations – soon became key players in developing corporate governance codes and recommendations.

For instance the Australian Corporate Governance Council, which developed the national corporate governance recommendations, was formed and chaired by the ASX. Likewise, the Danish recommendations for corporate governance have been drafted by the Committee on Corporate Governance of the Copenhagen Stock Exchange (now part of NASDAQ OMX). Euronext participated in the Lippens Commission which drafted the Belgian corporate governance code. Similar initiatives by stock exchanges are ongoing – last year, Euronext Lisbon contributed to the work of the Portuguese Institute for Corporate Governance which drafted the proposal for a code currently under consideration. [...] 

**Source:** Amico, Alissa and Hans Christiansen, The Role of Stock Exchanges in Corporate Governance, Financial Markets Trends, Vol. 1., 2009, OECD.

### 3. ‘Soft Law’: the ‘Comply or Explain’ Approach to Governance Regulation

**The Spread of Corporate Governance Codes and ‘Comply or Explain’ Regulation**

17. Regulators and exchanges have taken various approaches to implementation of corporate governance codes. The ‘soft law’ ‘comply or explain’ (CoE) approach to corporate governance was pioneered in the UK, with the introduction of 11 provisions of the Cadbury Code in the listing requirements. The premise of the CoE approach is that one size does not necessarily fit all, and that issuers should be given flexibility to adhere to the spirit of the Code, rather than its specific recommendations, but be able to explain the deviations convincingly. No regulatory sanctions or consequences for the listing status are previewed for non-compliance in the UK; CoE leaves enforcement to shareholders, through market-based mechanisms such as pricing and shareholder votes at general meetings. This approach differs
markedly from the ‘hard law’ approach subsequently taken by the US -- of which the Sarbanes-Oxley Act of 2002 is the most well – known element.

18. The CoE has the longest history in the UK (since 1994) and the effectiveness of this implementation policy was analyzed in several research projects. Arcot, Bruno, & Faure-Grimaud (2009) and Pensions and Investments Research Consultants (PIRC, 2007) conclude, for example, that the ‘soft law’ policy proved generally successful in promoting strong governance practices in the UK. The share of non-financial FTSE 350 companies reporting compliance with each of the eight requirements covered by the survey (Arcot et al., 2009) went up from 10 to 56% between 1998 and 2004. Only 14% were not in compliance with two or more requirements, and less than 5%, on three or more. The PIRC survey accounted for all requirements and found 33% of the FTSE 350 companies to be in full compliance in 2006. This survey also reported the compliance rates to be rising gradually.

19. These and other authors issued some warnings, however. First, in the absence of formal verification procedures, the self-reported level of compliance may not always be accurate. Second, very few explanations of deviations from the Code are meaningful and most companies use boilerplate formulae that do not vary from year to year. Third, the market discipline is far from being swift: shareholders tend to take action only when poor performance kicks in.

20. The UK-based company WM Morrison, for example, had not been in compliance with a majority of the Code’s recommendations for several years without presenting a compelling explanation. It had not experienced any particular pressure on stock valuations or board membership until it started issuing profit warnings in 2004. Only then did the shareholders take action to appoint independent directors (PIRC, 2007).

21. It is also worth a note that the UK regulation can no longer be considered a ‘pure case’ of CoE. The listing regime was altered in 2008, with Standard and Premium listing segments replacing the less clearly demarked Primary and Secondary markets that existed previously. The new Standard listing is basically linked to EU-wide securities regulation and does not preview the CoE rule, while the Premium segment presents a number of ‘super-equivalent’ ‘hard’ requirements in addition to those subjected to CoE. In this respect, the UK has moved towards a hybrid regulatory regime that presents a combination CoE and opt-in structures.

22. A number of countries followed the example of the US and the UK in adopting national corporate governance codes. According to Aguilera & Cuervo-Cazzura (2009:376), 64 countries issued 196 corporate governance codes by mid-2008. Most of them chose the ‘soft law’ approach to implementation as practiced in the UK, albeit many introduced some variations to its functioning. A section from the report by Amico & Christiansen (2009), reproduced in the textbox below, presents an overview of various approaches to CoE.

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**Box 2. Comply or explain in previous OECD work**

In the European Union countries, the adoption of CoE was facilitated by the adoption of the Directive 46 (2006) which has been integrated into the national regulatory frameworks of member states. In market places operating by CoE, a primary role for stock exchanges has been to ensure that company disclosures remain meaningful and are not reduced to a box-ticking exercise.

The CoE approach permits a number of permutations in terms of the level of disclosure and enforcement. For example, a listed company may be requested to disclose whether it is in compliance with individual recommendations of the code or merely with the code globally. In terms of the enforcement, the ability of exchanges or other regulators to pursue companies which do not provide adequate levels of disclosure also varies. In most cases, CoE codes are subject to some form of regulatory enforcement, but they may also be subject to enforcement largely by shareholders.
(e.g. Netherlands), or the question of enforcement may be more or less left to market forces (e.g. France). In most instances, stock exchanges are in some way involved in monitoring the compliance status – although, again, their ability to take enforcement action differs based on the legal basis of the code and the national securities regulation frameworks.

The most direct power of stock exchanges to enforce compliance obviously pertains to those standards which are also incorporated in the listing requirements. For instance, in the Australian model only those recommendations of the Code which are also part of the listing rules are subject to regular surveillance and enforcement by the ASX, whereas others recommendations are to be observed on the CoE basis. The NYSE can also enforce compliance with its Corporate Governance Listing Standards through a letter of reprimand or de-listing as the Standards are mandatory for listed equities, having been approved by SEC. Likewise, the Six Swiss Exchange can impose a variety of sanctions when the listing requirements and its implementing provisions (including those dealing with governance issues) are not complied with. Conversely, Euronext Paris is not equally empowered to take any enforcement actions given that the relevant governance recommendations are not part of its listing rules and have no legal status.

As most governance recommendations remain in the form of contractual “soft” rules, punitive measures that can be adopted by exchanges in relation to breaches of governance requirements are limited in most cases. In instances of significant and continued non-compliance, a typical response by an exchange would be to forward the matter to the appropriate securities regulator. In the short run, the stock exchange in most cases has the option of disclosing its unease about any given company's commitment to good practices of corporate governance. Following this, investors' assessment of the situation can be reflected through the pricing mechanism.


23. We note, however, that the CoE approach generally caused more controversy in some other markets than its pioneering application in the UK, and a range of institutional and cultural explanations were offered. In Italy, for example a research team from CONSOB, the securities markets regulator, surveyed the procedures for related party transactions at 256 companies listed on the MTA market of Milano’s Borsa Italiana in 2007 (Bianchi, Ciavarella, Novembre, and Signoretti, 2011). They found that while 86% of companies claimed to be in compliance with recommended procedures under Codice di Autodisciplina, in reality, the figure was closer to 33%. Companies with active minority investors and external directors were found to be more likely to comply with the recommended procedures in earnest.

24. While some observers noted improvement in governance practices of German companies, following the introduction of the ‘Cromme Code’ in 2002 and corresponding CoE requirements (e.g. Werder, Talaulicar, & Kolat, 2005), others were sceptical. Seidl, Sanderson, & Roberts (2009) compared the compliance rates between the UK and Germany and found that for the reporting year 2006, less than 15% of the largest 130 public German companies were in full compliance with the Cromme Code, as compared to over 50% top 130 UK companies reporting compliance with the Combined Code. Furthermore, the German regulator’s attempts to encourage adherence to specific provisions by including specific marks in stock exchange’s pricelists (similar in a way to the Italian STAR designation), were found ineffective, and in both cases had to be replaced with ‘hard law’ (Wymeersch, 2006). In particular, that was the case with insider trading rules and takeover regulations. The recommendation to disclose individual executive compensation faced a similar fate: the initial CoE approach resulted in very low disclosure rates, prompting the introduction of a ‘hard law’ requirement in 2006. The new regulation required listed companies to disclose individual executive compensation unless 75% of shareholders approve a waiver. Apparently, in a country like Germany, companies might be accustomed to ‘hard’ regulations and therefore less susceptible to ‘soft rules’ provided by the CoE approach (Seidl et al., 2009).

25. In the case of Turkey, the ‘soft law’ approach produced very modest benefits in terms of governance improvements, despite the market stimuli devised to promote compliance. This example is discussed in more detail below.
The Case of the Istanbul Stock Exchange

26. Turkey has sought to develop its financial markets since about the turn of the century, following the bank crisis on 2000. The Capital Markets Board of Turkey (CMBT) issued the Corporate Governance Principles in 2003, based on the OECD Principles and developed in consultation with the Istanbul Stock Exchange and prominent academics (OECD, 2006). CMBT adopted a ‘soft law’ approach to implementation; a ‘comply-or-explain’ requirement was introduced in 2005. The 2007 launch of the Corporate Governance Index on the ISE, composed of companies in compliance with most principles according to independent ratings, was intended as a stimulus for issuers. This move was similar to the assignment of STAR designation to compliant companies in Italy and (the now-defunct) compliance markings for German companies.

27. The CMBT Code is composed of 26 basic principles, of which most are supplemented by several specific recommendations numbering over 100 in total. With very few exceptions, these recommendations became subject to CoE requirement, resulting in a considerable reporting complexity.

28. Among other things, these principles called for “avoidance” of unfair nominating and voting privileges, recommended cumulative voting in board elections, transparency of beneficial ownership and group structure, required that one third of board members, but no fewer than two directors, be independent, and form independent nominations/corporate governance and audit committees. It also presented a number of disclosure requirements with regards to trades in issuer’s shares by executives, directors and shareholders owning more than 5%.

29. Although covering a very broad range of governance issues, the Principles did not set clear priorities in terms of governance improvements. The abundance of recommendations led to a lack of focus; as a result, many Turkish companies were able to achieve high compliance ratings without undertaking serious changes in their governance structures or philosophies. Many did so in the absence of meaningful checks and balances or minority protections. Despite an explicit recommendation to that effect, no single Turkish company has ventured to adopt cumulative voting, only 16% of listed issuers had independent directors (in most cases, one or two) and none met the recommended quota of one third of independent board members by 2008 (Ararat, 2011).

30. Many controlling families continued to hold shares with special nomination rights that rendered the work of board-level nomination committees meaningless (i.e. since boards and board-level committees lacked the legal authority to make nominations). At the same time, the existence of these committees contributed to compliance ratings of Turkish companies. Many blockholders were able to maintain a grip on decision-making by appointing ‘designated’ directors. While these directors had no formal executive functions and were occasionally considered non-executive for compliance purposes, more often than not, ‘designated’ directors acted as the real CEOs (Ararat, 2011).

31. Turktelecom, for example, reported on its Web site a compliance rating of 8.27, assigned by the accredited SAHA domestic rating company in 2010, comfortably above the level of ‘7’ required for inclusion in the Corporate Governance Index. At the same time, the company’s compliance report indicated that it did not have a single independent director and neither did it find one necessary ‘in ordinary circumstances’. The company also did not use cumulative voting procedures because it found them ‘impractical’.

32. It is therefore not surprising that, despite the requirement for external assessment of compliance reports, the CoE approach in Turkey did not make a significant effect on board compositions, as it did in the UK. Apparently, in applying the global OECD principles, the CMBT Corporate Governance Principles
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and the Index methodology did not sufficiently account for specific norms of Turkish Law, and therefore lacked the edge in terms of relevant governance risks.

33. The Corporate Governance Index eventually failed to develop into an investment tool and its criteria were criticized for failing to provide links to performance -- or hedge against gross abuse of minority investors (Ararat, 2011). On 30 December 2011, the Corporate Governance Index closed about 1.4% below its value at initiation on 31 August 2008, underperforming XU100, the main index of the ISE, which gained 3.8% over the same period.

4. Other Initiatives by Stock Exchanges: the Opt-in and Hybrid Regulation Regimes

34. Alternatives to CoE include opt-in listing systems that allow issuers to voluntarily choose a trading floor that presents a particular scope of governance requirements. The advantage of this approach includes clear differentiation of issuers according to their governance standards: a listing level is a lot more conspicuous and easier to account for in investment decisions than a compliance report. This approach also provides an enforcement tool in the form of a change in a listing status. At the same time, this approach allows the exchanges to address the requirements of a broad range of investors and issuers.

35. A section of the earlier OECD report, reproduced in the textbox below, presents a survey of how the ‘good governance’ markets and ‘alternative segments’ were introduced at several exchanges. The example of BOVESPA’s ‘good governance’ segments, perhaps the most notable among the emerging markets’ exchanges, is described in the next section.

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<th>Box 3. Governance oriented listing segments in previous OECD work</th>
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<td>In contributing to the design of the corporate governance framework for listed companies, exchanges have been active in providing incentives to already listed companies to commit to higher governance standards. Perhaps the most widely known manifestation of this approach has been the establishment of Novo Mercado by the Brazilian Stock Exchange. This approach effectively provides an incentive for already listed companies motivated by the prospect of index-trading to improve their governance.</td>
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<td>In addition to creating higher governance segments, exchanges have also sought to create custom governance regimes through the creation of standards targeted to specific tiers or compartments, in order to facilitate capital needs of a variety of listed companies. For example, the LSE has differentiated the application of the Combined Code such that AIM-listed companies are exempt from it and the FSA Listing Authority Rules, while Main Market companies are to observe it on a CoE basis. Instead, AIM-listed companies are subject to lighter governance requirements that seek to address more basic shareholder protection issues (i.e. shareholder approval of significant transactions).</td>
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<td>On the one hand, some have interpreted this approach as a relaxation of governance standards on lower tiers or on the market more generally. For instance, Alternext-listed companies are not subject to any of the corporate governance codes applicable in the four jurisdictions covered by the Euronext main market. On the other hand, insofar as these new segments mostly do not compete head-to-head with old exchanges for the same listings the approach can equally be seen as an adaptation of governance requirements to suit the size and type of prospective issuers. Through multiple listing tiers, exchanges may actually have improved the governance and transparency of small and medium size issuers, which might not have listed in the absence of such preferential treatment.</td>
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<td>In multiple-tier markets, stock exchange operators have also supported the transition of companies from less regulated compartments for small cap companies to their main markets, in a number of instances providing assistance to companies adopting the required higher governance standards. For instance, the TSX facilitates the transition of companies from its Venture Exchange to its main market, which features higher governance requirements. The TSX also provides a range of incentives for companies wishing to switch, such as waiving listing application fees or reducing documentation requirements.</td>
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Awareness raising efforts have also played a role
In addition to being at the forefront of development of governance codes and recommendations, some exchanges have been actively involved in increasing the awareness around the value of good corporate governance. For instance, in 2008 the Warsaw Stock Exchange has decided to establish a group of educational partners from across the country to co-organise training sessions and other educational projects in order to increase the awareness of good governance practices and the recently amended Code of Best Practice for WSE Listed Companies.

Finally, stock exchange alliances and increasing collaboration is acting to improve governance standards globally. Through exchange alliances and initiatives to attract dual listings, exchanges are also helping to spread good governance standards globally. For instance, NASDAQ OMX has been active in providing counselling to exchanges in Eastern Europe and the Middle East on how to improve transparency and disclosure in their local market through sharing its experiences in this area. Though it is debatable whether such initiatives will lead to regulatory harmonisation, it is clear that they can lead to potential improvements of governance standards in emerging markets.


The Voluntary Markets of BOVESPA

36. BM&FBOVESPA, the largest exchange in Latin America based in Sao Paolo (Brazil) received multiple praises in recent years for its novel approach to integrating governance standards in its listing requirements.

37. Recognizing the prevailing governance weaknesses of Brazilian companies, BOVESPA launched its famous Novo Mercado listing segment (as well as two intermediate segments, Nivel 1 and Nivel 2, and a special section of the OTC market, BOVESPA MAIS) in 2000. These segments represented an opt-in system for those issuers that wished to signal their commitment to governance standards exceeding the regulatory requirements for public companies (Borodina & Shvyrykov, 2010).

38. This move reflected a private initiative of the exchange and went beyond the legal and regulatory requirements of the time. Importantly, the norms included in listing rules were developed in consultation with international portfolio investors and reflected those aspects of corporate governance that were of primary concerns to minorities in Brazilian companies. Among other issues, these included the prevalence of non-voting variable-dividend preferred shares in public float, which resulted in a gross disparity between shareholder rights available to founding families (that held mainly common stock), and minority investors that held mainly preferred shares.

39. The mandatory bid rule (in the event of takeover) was re-introduced in Brazilian company law in 2002, having been dropped a decade earlier in a controversial attempt to facilitate privatizations. Re-enacted, this rule did not extend to preferred shares, however, effectively denying preferred shareholders their share in the control premium. Moreover, the disparity of rights available to controlling shareholders and the minorities was aggravated by the notorious sloth of the judiciary, making any defence of minority interests next to impossible.

40. Taken together, these factors contributed to Brazil having very modest financial markets, with weak liquidity, low trading volumes, and virtually non-existent public placements in the late 90s and the early years of the 21st century.

41. Novo Mercado addressed these concerns by requiring that issuers have only one class of shares; the intermediate segment Nivel 2 allowed preferred shares, but required, among other things, that mandatory bid rules extend to these shares (at 80% of the price offered per ordinary share) and that preferred shareholders have a vote on major corporate decisions (such as mergers, spin-offs and incorporation), as well as transactions with entities related to controlling shareholder. To strengthen, disclosure, BOVESPA required that statutory quarterly reports present consolidated accounts and be
reviewed by independent auditors. In addition, Nivel 2 and Novo Mercado required annual IFRS/US GAAP accounts (see table 1). At the regulatory level, IFRS reporting became mandatory for public companies in Brazil only in 2011.

Table 1. Premium listing segments of BM&FBOVESPA

<table>
<thead>
<tr>
<th>Novo Mercado</th>
<th>Nivel 2</th>
<th>Nivel 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common shares only</td>
<td>Preferred shares are acceptable, but must have a vote on certain related party transactions, spin-offs, etc.</td>
<td>--</td>
</tr>
<tr>
<td>Public placements must target dispersion</td>
<td>Public placements must target dispersion</td>
<td>Public placements must target dispersion</td>
</tr>
<tr>
<td>Minimum free float 25%</td>
<td>Minimum free float 25%</td>
<td>Minimum free float 25%</td>
</tr>
<tr>
<td>Mandatory bid at 100% of price paid to majority owner</td>
<td>Mandatory bid at 100% to common, 80% to preferred shareholders</td>
<td>--</td>
</tr>
<tr>
<td>20% independents, 2-year board mandate</td>
<td>20% independents board members, 2-year board mandate</td>
<td>--</td>
</tr>
<tr>
<td>Annual accounts under IFRS or US GAAP</td>
<td>Annual accounts under IFRS or US GAAP</td>
<td>--</td>
</tr>
<tr>
<td>Reviewed consolidated statements in quarterly reports</td>
<td>Reviewed consolidated statements in quarterly reports</td>
<td>Reviewed consolidated statements in quarterly reports</td>
</tr>
<tr>
<td>Disclosure of trades by controlling shareholder</td>
<td>Disclosure of trades by controlling shareholder</td>
<td>Disclosure of trades by controlling shareholder</td>
</tr>
<tr>
<td>Dispute resolution at Market Arbitration Panel</td>
<td>Dispute resolution at Market Arbitration Panel</td>
<td>--</td>
</tr>
<tr>
<td>Mandatory bid at fair price on delisting</td>
<td>Mandatory bid at fair price on delisting</td>
<td>--</td>
</tr>
</tbody>
</table>

42. Yet another important initiative, addressing the weakness of the judiciary in Brazil, was the requirement that listed issuers (Novo Mercado and Nivel 2) submit to resolutions of the Market Arbitration Panel of the exchange in resolving corporate disputes. Finally, to ensure the robustness of commitments associated with listing requirements, controlling shareholders of de-listing companies were required to make a tender offer for all outstanding shares. The fair value of the bid must be determined by a renowned appraiser approved by minority shareholders.

43. Obviously, BOVESPA chose to focus on the most relevant and attainable governance traits in its listing requirements rather than embrace the entire universe of best governance practices. The quotas for independent directors are fairly modest, for example. There is no requirement for cumulative voting (under the company law, it must be used upon shareholders’ request, but this hardly ever happens in practice). Hand-voting is allowed and not uncommon at shareholder meetings, while most publicly traded banks serve as their own registrars. There is no requirement for board-level audit committees to be created and
most companies leave respective functions to statutory audit boards (consejo fiscal) composed of non-directors.

44. Far from being exhaustive in their listing requirements, the opt-in markets of BOVESPA nevertheless made a significant impact on governance practices at Brazilian companies. They presented a concise list of value-laden yet attainable criteria and a clear tool for communicating the company’s adherence to them, in the form of the listing status. Strict de-listing rules ascertained the persistence of commitments associated with the listing.

45. The swift development of these markets attested to the success of their design. The number of Brazilian IPOs soared, peaking at 64 in 2007. Between 2004 and 2010, 73% or all IPOs were on Novo Mercado, and 14% on Nivel 2 (Fraga, 2010). By the middle of 2011, the number of Novo Mercado companies reached 123 – i.e. about a quarter of all BOVESPA-listed companies. 18 companies were listed on Nivel 2, and another 30 – on Nivel 1. Combined, these special segments accounted for 35% of all listed issuers, 65.4% of market cap, 79.5% of turnover and 74.8% of trades (BM&FBOVESPA News, July 2011).

46. Most US-listed Brazilian companies chose to cross-list on BOVESPA’s premium segments that presented greater and better targeted governance requirements than those applicable to foreign issuers in the US (e.g. foreign issuers in the US may merely present a reconciliation with US GAAP, while BOVESPA requires full-blown US GAAP or IFRS accounts). Gledson de Carvalho & Pennacchi (2011), for example, analyzed the valuation effect of BOVESPA premium listings by Brazilian companies and found positive market reaction to listings that was stronger for higher-level listings. This effect was most pronounced for preferred shares that achieved not only higher valuations, but also greater liquidity.

47. The IGC Index, composed of companies included in the Novo Mercado, Nivel 1 and Nivel 2, consistently outperformed the main market indices. IGC Index was launched on 25 June 2001 with an initial value of 1000, and reached 6679.9 on 29 December 2011, significantly outperforming IBOVESPA, the default market index in Brazil. While IGT showed a cumulative return of 568%, IBOVESPA gained 290% over the same period.

5. The Joint Exchange of Moscow: Existing and Envisaged Regulations

48. In its drive to raise the profile of Moscow as an international financial centre, Russia has initiated an ambitious reform of corporate law intended to close the loopholes exposed in practice and improve investor protection overall. Some of these initiatives are directly related to the functioning of stock exchanges, such as the encouragement for exchanges to merge and grow the scale of operations, creation of a central depository, and the new insider trading law. There have been calls for a major review of the listing system from the regulators and other stakeholders, yet these calls did not really signal any particular ambition in terms of strengthening of governance-related requirements.

49. The basic regulatory framework for security issuers in Russia represents a ‘hard law’ approach to disclosure that applies to all filers of domestic offering memoranda (on shares or debt securities). It presents continuing disclosure obligations in the form of voluminous quarterly reports that include among other things, the detailed operating information, accounts under Russian GAAP, a full list of related-party transactions (compiled from the stand-alone perspective), a full list of subsidiaries and affiliates, and some governance data. Issuers are also required to make specific filings such as ‘material facts notice’ and ‘affiliated entities list’. The main drawbacks of these disclosures follow from their stand-alone approach to reporting as well as their being unaudited and sporadically enforced. Some issuers, for example, refuse to present mandatory information such as executive compensation figures, while others present such aggregate data without explaining what was included in it.
50. Regulation expressly addressing corporate governance was introduced in 2002, with the publication of the Corporate Governance Codes by FCSM, the securities markets regulator of the time. Even by the measure ‘soft law’, the regulator took a light approach in recommending that all joint stock companies (i.e. including the closely held entities) implement the Code’s provisions and voluntarily adopt CoE reporting in annual reports and statutory filings for the fourth quarter. No enforcement mechanism was provided. Although some companies did follow the recommendation, it had little practical consequences for governance practices.

51. The most tangible outcome of the Code came in the form of governance-related provisions of listing requirements, based on the Code’s recommendation. These requirements are presented in Table 2, as effective on 1 February, 2012.

<table>
<thead>
<tr>
<th></th>
<th>A1, A2</th>
<th>B, V</th>
<th>I</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent directors</td>
<td>3</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Audit committee</td>
<td>fully independent; failing that, non-executive</td>
<td>fully non-executive</td>
<td>not required</td>
</tr>
<tr>
<td>HR &amp; Compensation committee</td>
<td>fully independent; failing that, non-executive</td>
<td>fully non-executive</td>
<td>not required</td>
</tr>
<tr>
<td>30-day notice of AGMs</td>
<td>Yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Directors and executives required to report ownership and trades in issuer’s shares</td>
<td>Yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Audited annual IFRS/US GAAP accounts</td>
<td>yes</td>
<td>not required</td>
<td>not required</td>
</tr>
<tr>
<td>Maximum ownership concentration</td>
<td>75%</td>
<td>90% (B) no cap provided (V)</td>
<td>No cap provided</td>
</tr>
</tbody>
</table>

52. These requirements should be viewed in conjunction with relevant provisions of Russian company law – such as mandatory cumulative voting in board elections, liberal nomination and voting procedures, one-year director terms and registrar’s independence. Yet vividly missing from these requirements are interim disclosure obligations under IFRS or US GAAP, timing requirements for annual IFRS accounts, disclosure of beneficial ownership, (consolidated) related party transactions and executive compensation. The listing requirements regarding internal audit and controls are fairly vague, while the Code’s criteria for director’s independence have been criticized for lack of scope and detail. Policies regarding cross-holdings and indirectly held treasury shares were not formulated. While exchanges are formally required to provide surveillance of governance standards of listed companies, their effectiveness in enforcement is unproven. Finally, no protections for shareholders are previewed in the event of a de-listing, or a downgrade in the listing status.

53. For this and other reasons, the listing requirements also had a limited effect on governance practices – in fact, foreign listings and cross-listings had a stronger influence. The A-level trading lists on
the MICEX, the only markets to present meaningful governance requirements with respect to equity issuers, included only 37 such companies as of 1 February 2012 – similar to the number of Russian companies exposed only to foreign listing requirements. This is also a mere fraction of the total number of traded Russian companies: the lower markets included 71 issuers, another 232 were traded ‘outside lists’, and 991 were traded over-the-counter on ‘RTS Board’. In the most publicized example, Gazprom, the largest issuer in Russia, is traded ‘outside lists’.

54. Standard & Poor’s reported that, as of May 2011, five Russian companies were listed in the US (three on the NYSE and two on NASDAQ). Two companies were listed on Stockholm Stock Exchange, and one on each of the exchanges of Warsaw, Hong Kong, and Frankfurt (XETRA). Over 61 were traded on the Main (44) or AIM (17) markets of the London Stock Exchange. 32 companies were present on the LSE’s markets through depositary receipts, and 29, through non-Russian incorporation of the issuing entity. More than 30 companies with primarily Russian operations were traded only outside Russia, despite the introduction of Russian depositary receipts in 2010 (Standard & Poor’s, 2011: 12).

6. **Conclusions: How Does Russia Stack Up Against Peers?**

55. Based on the examples above, the answer is probably ‘not really well’. Despite Moscow’s direct competition with other financial centres, and significant governance-related concerns that prevail with respect to domestic issuers, the MICEX-RTS exchange has not really adopted any of the regulatory mechanisms that exist in other markets. In a sense, Russian companies have no choice other than to use foreign premium markets – usually in conjunction with foreign incorporation -- to signal their commitment to strong corporate governance standards. The very recent examples of Polymetal Inc., Evraz Holding S.A. (both obtained the LSE’s Premium listing in 2011) and Yandex NV (performed an IPO on NASDAQ in 2011) bear witness to this phenomenon.

56. The existing CoE approach was initiated by the government -- not the exchanges or investors -- and represents a light version of what has been only a moderately successful regulatory policy on most markets (bar the UK, where it co-exists with the opt-in system). The mixed experience of other civil law countries, inclined toward ‘hard law’, presents some warnings regarding the inherent limitations of this policy in its further use in Russia – even if it assumes the detail, focus, and enforcement that it currently lacks.

57. There is indeed a choice of voluntary markets available to large issuers (i.e. there are minimum liquidity criteria), yet these listing criteria are relatively lax and suffer from the same loopholes and vagueness in definitions that characterize the Code and accompanying decrees. Most importantly, they do not effectively address the prevalent governance risks specific to concentrated ownership. While the success of BOVESPA, for example, was to some extent premised on the early involvement of international portfolio investors in the formulation of listing criteria, this was not – and remains not to be – the case in Russia.

58. That said, things may be starting to change. The political ambition to develop Moscow’s profile as a financial centre, as well as the on-going reform of corporate law, addresses the most basic weaknesses of Russian law, including those with respect to transparency of ownership and affiliation criteria. This may open opportunities for regulators and exchanges to build on – or anticipate – the increasing aptitude of law in terms of governance regulations. At a very minimum, this may include the clarification and strengthening of the requirements pertaining to free float, director independence, disclosure standards and de-listing terms.
TRANSPARENCY & DISCLOSURE: THE ROLE OF LISTING RULES

1. Executive summary

59. Transparency of public Russian companies remains below that of peers in the developed world, and lags behind some advanced emerging markets such as Brazil. According to Standard & Poor's 2010 research, Russian companies cross-listed in the US score on average about 25 points higher on a 100-point disclosure scale, and London-listed companies, 15 points higher, than companies listed in Russia only. Although a part of that effect may be market-driven rather than normative, the wide difference between these figures, as well as the wide overall range of observed scores (25 to 80) among Russian companies suggests that minimum disclosure standards by Russian public companies are not effectively enforced by the exchanges and regulators.

60. The existing listing rules present specific disclosure requirements (i.e. annual IFRS accounts) only with respect to the sparsely populated upper markets and even in that case, add relatively little to statutory disclosure obligations applicable to all issuers of publicly traded securities. Moreover, these requirements are set to become redundant in 2013 once the new Law of Consolidated Financial Statements comes into force.

61. Transparency in the areas of related party transactions, executive compensation and board practices appears to be particularly weak. Timing of annual IFRS reporting is not regulated by listing rules and there is no requirement for interim IFRS disclosure neither in current listing rules nor in the upcoming 'hard law' regulations. There are no specific requirements pertaining to disclosure of ultimate ownership, or conflicts of interest that could potentially affect significant shareholders and directors, or the level of detail with respect to related party transactions. This is an important oversight in our view since these issues are directly linked to the prevalent forms of governance risks in the Russian corporate sector; better disclosure in these areas could potentially provide investors with important tools for assessing and pricing these risks accurately.

62. All the above weaknesses represent opportunities for Russian exchanges encourage investor confidence through listing regimes that, at least in the case of upper segments, not only bridge the gaps in regulatory requirements, but also address the specific information needs of investors in Russian securities. This move could potentially pave the way for achieving disclosure levels comparable with those of the world's leading financial centres and the most advanced emerging markets.

2. Prevailing Forms of Regulation and Global Best Practice

63. While the benchmark of annual IFRS/US GAAP disclosure has become the norm for most public interest entities across the globe, national regulations and listing requirements vary widely in terms frequency and timing of financial disclosure, as well as ownership disclosure, scope of governance-related disclosure (including the sensitive issue of executive and director compensation), disclosure on risks, strategic plans, related party transactions, conflicts of interest, etc.

64. Arguably, the US continues to represent the gold standard in terms of disclosure. This is achieved by the use of the stringent rules of US GAAP for financial reporting, which require detailed disclosure of related party transactions, financial investments, pension liabilities etc., often beyond the scope mandated by IFRS. At the same time, disclosure in proxy statements (by US-incorporated firms) presents very detailed information on governance practices, and particularly, the executive compensation, including equity-based pay and benefits. The statutory 10K report comprises extensive information on operating
performance, risks and strategy. Financial results are released quarterly, usually within 21 days after the end of reporting quarter, and in most cases are accompanied by detailed management discussion and analysis section. The main body of disclosure regulations in the US are statutory, although there is room for exchanges to present their own requirements.

65. We note, however, that transparency regimes shown by some emerging markets are becoming increasingly competitive. While an increasing number of countries are switching to IFRS as the base standard, which raises the bar in financial reporting globally, some markets have gone much farther than merely requiring public companies to present annual IFRS reports. The premium segments of BOVESPA, for example, required consolidated (instead of mandatory stand-alone) accounts in statutory quarterly reports as well as presented a number of requirements with respect to governance-related information. And the Hong Kong stock exchange requires detailed account of board procedures and conflicts of interest to which shareholders and directors are exposed.

66. Standard & Poor’s performed a number of transparency surveys across the globe between 2001 and 2010, yet the later surveys had limited coverage. Already in 2002-2003, the average figures for the US and UK companies were the highest, with country averages at 70% and 71% (of the ideally desirable scope) respectively. Companies from (the other) EU countries scored somewhat lower as this was before the introduction of mandatory IFRS reporting. The average for Germany was 56%, and France, 68%. Japan scored 61%.

67. In the same survey, Russia was among the least impressive performers, with an average score of 34% for 42 public companies in 2002 – below the average for South-East Asia (48) and only marginally above Latin America (31).

Figure 1. Standard & Poor’s Transparency and Disclosure Indices for selected countries.

68. In subsequent years, several surveys by Standard & Poor’s were conducted with a narrower geographic scope. One of them, conducted in 2006, has placed the disclosure standards of Turkish companies at 66%, which is reasonably high, particularly by the measure of emerging markets. The introduction of mandatory IFRS reporting and ‘comply-or-explain’ requirements since 2005 had clearly played a role in that. Brazil made a similarly strong showing in the 2009 survey, also with an average score of 66% for the 56 companies included in the IBOVESPA Index -- despite the fact that IFRS became statutory only two years later. The main credit for this goes to the listing requirements of BOVESPA (where several segments required IFRS or US GAAP disclosure) and the NYSE, which raised the availability of information in English. Companies with dual US listings scored 72% on average, and those with domestic listings only, 60%.
69. The 2008 survey of 300 largest public Chinese (A-share) companies showed some interesting results. While the average score for the entire sample was only 46%, the 34 companies cross-listed in Hong Kong, had an average transparency score of 69%, and 251 “pure” domestic A-shares, 43%.

70. Finally, the 2009 survey of Kazakhstan showed that mandatory IFRS reporting alone is not sufficient to ensure strong overall disclosure in the marketplace. The average for 22 largest public companies was 44%, slightly below China’s average, with the main shortfalls occurring in disclosure on operations, corporate governance, and availability of English-language disclosure. Apparently, the “equity culture” was only starting to develop in Kazakhstan, with many companies providing limited disclosure in annual reports to shareholders and publishing them fairly late.

3. Russian Case – The Existing and Evolving Regulations for Transparency & Disclosure

71. Under Russian Law, companies are subjected to disclosure regulations once they are considered issuers upon the filing of an offering memorandum (i.e. for equity or public debt). Regulations that ensue upon such filing present continuing disclosure obligations in the form of voluminous quarterly reports that include among other things, the detailed operating information, accounts under Russian GAAP, a full list of related-party transactions (compiled from the stand-alone perspective), a full list of subsidiaries and affiliates, and some governance data. Issuers are also required to make specific filings such as ‘material facts notice’ and ‘affiliated entities list’. The main drawbacks of these disclosures follow from their stand-alone approach to reporting as well as their being unaudited and sporadically enforced. A separate regulatory regime applies to banks that face a number of filing requirements, including that for annual accounts under the specific version of IFRS devised by the Central Bank.

72. The passing of the Law on Consolidated Financial Reporting in Russia (and the supporting executive orders) extends the requirement for audited annual IFRS reports to all issuers of securities (including debt securities) traded on organized exchanges since 2013 (i.e. starting with the FY 2012 accounts). However, this requirement will extend to companies that do not have equity traded – or currently report under US GAAP – only in 2015. Audited annual accounts must be released within four months after the end of the reporting year. This is an important step forward, and yet it leaves substantial leeway for stock exchanges to stimulate further transparency of public companies, bringing the overall level of transparency in the marketplace closer to such standards seen in the other markets. For example, the new regulation does not provide any requirements with respect to interim IFRS. There is also scope for additional requirements with respect to non-financial information, including those on corporate governance.

73. Despite the envisaged proliferation of IFRS, reporting under Russian Accounting Standards remains statutory, despite its limited use to investors and policy-makers. This is different from the policy of the neighbouring Kazakhstan, for example, which waived all reporting under national standards since the introduction of IFRS. The need to maintain two parallel reporting systems – of which both must be audited – increases the burden on companies and complicates a timely publication of IFRS accounts. Timing remains an issue, however: only 51% of companies in the S&P survey met the conventional international requirements in 2010 by publishing the audited annual IFRS or US GAAP accounts before the end of April, while 26% did not even do that in time for the shareholder meetings (usually held in the end of June in Russia). While the new law is set to improve the reporting discipline in terms of annual results, the presence of dual reporting requirements is likely to impede progress beyond the mandated timeline and also with respect to interim reports.

74. Listing rules provide only a fairly thin overlay over the statutory disclosure regime pertaining to all ‘issuers’. The requirement to present audited annual IFRS reports, albeit with uncertain timing, is the only meaningful disclosure obligation under the listing rules and it applies only to the A-level markets, a fairly
narrow segment of traded companies. The ‘comply-or-explain’ recommendation with respect to the national Corporate Governance Code applies to all joint stock companies and therefore not linked to listing requirements.

4. **Russian Disclosure Standards Vis-à-Vis Other Markets**

75. While regulations pertaining to disclosure by Russian companies saw few changes over the course of the last decade, the average disclosure standards have risen both as a result of foreign listings and voluntary improvements by individual companies. The evolution of Standard & Poor’s Russian Transparency Index (not repeated in 2011) is shown in figure 2, below.

![Figure 2. Standard & Poor's Russian Transparency and Disclosure Index](image)

76. A couple of observations are warranted here. First, it is worth a note that the index effectively reached a plateau in 2007, with very little improvement in subsequent years. This may reflect the fact that disclosure requirements applicable to foreign issuers on the London Stock Exchange – an exchange of choice for most Russian companies – are relatively mild, and having met those requirements, few companies choose to go beyond them. This is illustrated by figure 2, which shows that the average disclosure score for 29 Russian companies in the sample that were traded in London (as of 2010) was 66%, while the 5 companies facing the more stringent US disclosure requirements (mainly in the form of the 20-F report, but also the more detailed footnotes to financial reports mandated by US GAAP) had an average disclosure score of 76%. The 53 companies without a foreign listing or cross-listing, had an average of 51%. Second, one should bear in mind that the methodology of S&P surveys takes the perspective of English-speaking international investors; it does not penalize companies for providing certain disclosures only in English. And while Russian companies publish financial statements and annual reports in English and Russian simultaneously, filings to the SEC, such as the 20-F report, are in most cases not translated into Russian and therefore not helpful to a significant share of domestic retail investors.

77. The limited regulatory framework for corporate transparency in Russia results in a wide variance in disclosure standards at individual companies. In the 2009 Brazil survey of Standard & Poor’s, no company scored lower than 44%, for example, even though this was before the introduction of statutory IFRS reporting. The range of observed scores was 35 percentage points (i.e. 44 to 79). In the 2010 Russia survey, the lowest observed score was 25%, and the range of observed scores, 55 percentage points (i.e. 25
to 80). In other words, the regulatory floor for disclosure standards appears to be much lower in the case of Russia. The most direct form of regulation, in the form of government ownership, was also not associated with greater transparency in the S&P surveys. In most years, average scores for subsamples of private and government-controlled companies were very close or the latter scores only marginally higher, despite the significantly greater average size of government-controlled companies in the samples.

5. **Conclusions – what are the main areas for improvement**

78. As evidenced by various surveys cited in this report, the average disclosure standards of large public Russian companies remain below that of the developed countries and some advanced emerging economies such as Brazil. In addition, there is high variance among disclosure levels of individual companies, which signals low effectiveness of disclosure requirements both at the regulatory level and listing rules.

79. With no particular regulatory rigor in sight despite recent changes, Russian exchanges face the choice of either accepting the uneven transparency of listed companies, with all the practical and reputational consequences -- or introduce additional disclosure requirements for all or selected listing levels. In view of the recent ambition of the Russian government to raise the profile of Moscow as an international financial centre, and the plans of MICEX-RTS to expand its business, the latter option appears more logical.

80. At least with respect to domestic issuers, Russian exchanges are uniquely positioned to develop a set of disclosure rules that directly target the gaps in statutory disclosure requirements, but also account for specific information demands associated with prevalent financial and non-financial risks at Russian companies. Thus, the interim IFRS reporting is overlooked by the existing and impending regulations. Governance-related information is also highly relevant in this sense, including the information on external business interests of significant shareholder and conflicts of interest to which such shareholders and board members are exposed. Detailed account of related party transactions is equally important, often beyond the scope mandated by IFRS. Reliable information on executive compensation, at least at an aggregate level, is also vividly missing from Russian companies' reports, while such statutory disclosures are notoriously misleading.

81. While this report was not intended to produce a comprehensive list of disclosure gaps, issues cited above represent important shortfalls in current disclosure practices, and therefore, opportunities for the listing rules to intervene. A thorough dialogue with the community of domestic and international investors -- the ultimate consumers of information -- might be needed to reveal a more complete scope of disclosure gaps by Russian companies, as well as their priorities in terms of transparency.
REGULATION ON INSIDER TRADING AND MARKET MANIPULATION

1. Executive summary

82. Although some elements of insider trading regulations existed in Russia since mid-90s, a holistic approach to regulation of insider trading and market manipulation was introduced in the body of Russian Law in 2010, about 20 years after such development in the European Union. The enforcement has not yet started in earnest, however, and criminal liability has been postponed until 2013.

83. The new law presents a general definition of insider information, and clearly prohibits trading on the basis, or spreading such information. The definition of insider information starts with a general principle in a wording resembling that of the UK Criminal Justice Act. However, unlike such definitions in most other jurisdictions, the definition in the Russian Law concludes with an explicit reference to an exhaustive list of material events issued by the Federal Financial Markets Service. This means that in practice, rules prevail over principle, and enforcement may only be possible with respect to insider information conforming with one of the events cited in the regulator’s list.

84. In our view, Russia faces an important junction whereby today’s policy choices may significantly influence the future development of its financial markets. The basic principles stated in the new legislation present necessary inputs for an effective regulatory regime to emerge, yet enforcement practices remain to be developed. This step is crucial, however: as some recent academic work has shown, from the perspective of financial markets, no insider trading law is better than an existing law that is not enforced (Bhattacharya & Daouk, 2009).

85. The main challenges to effective enforcement, in our view, include the restrictive definition of material information, as well as the lack of blackout periods for corporate insiders, relatively mild administrative sanctions under the existing regulation, lack of experience of courts with respect to penal sanctions provided for misuse of inside information and market manipulation.

2. Prevailing Forms of Regulation and Global Best Practice

86. Insider trading undermines investor confidence in the fairness and integrity of the securities markets. For this reason, nearly every jurisdiction has enacted legislation prohibiting such activity. Although there are some variations in the legal systems of different countries, the majority of legislators adopting statutes relating to insider trading addressed the following issues: What is inside information? Who can be considered an insider? What activities related to using inside information are prohibited? How to prevent insider trading? What sanctions and enforcement measures should be implemented? (IOSCO, 2003: 1)

87. Pioneered in the US with the passing of the Securities Exchange Act of 1934, regulation of insider trading has been gradually introduced in a majority of jurisdictions, including the emerging markets. Bhattacharaya & Daouk (2009) estimated that prohibitions on insider trading existed in 80% of emerging markets, however, on 70% of these markets, these regulations were not enforced.

88. Two key defining characteristics of insider information are confidentiality and materiality. Information is usually considered confidential if it has not been made public. Although intuitively appealing, this criterion may not always be applied in a straightforward manner since public dissemination does not always occur simultaneously on all markets where the issuers’ securities are traded – and even within a single market, an infrastructure for dissemination of price sensitive information is not always
sufficiently effective to provide equal and timely access to all market participants. In addressing this issue, most jurisdictions have mandated procedures for public dissemination of information (as did Russia), and cross-border cooperation of regulators was called for (IOSCO, 2003).

89. Materiality relates to the potential of the information, once made public, to influence the price of securities in a significant manner. Some jurisdictions (this includes Russia and the UK) specify that to be considered material, the information must be precise and/or specific, but do not present a practical definition of the criterion (IOSCO, 2003). To facilitate enforcements, regulators in some emerging markets (e.g. Malaysia) presented a catalogue of events information regarding which must always be considered material. Russia went even further in presenting an exhaustive list of events to be considered material.

90. In defining insiders, most jurisdictions make a distinction between primary and secondary insiders (while Russian regulation does not). Primary insiders are usually presumed to have access to inside information and the knowledge to assess its materiality. As a consequence, they usually face harsher sanctions for abusing insider information than secondary insiders. Primary insiders usually include members of management and supervisory boards, and often, employees of the issuer, and service providers, such as external lawyers and consultants. Some jurisdictions also include significant shareholders in the list of primary insiders, as well as employees of the securities regulator.

91. Secondary insiders are persons who get inside information from someone else, not necessarily from a primary insider, and in some cases, even accidentally (IOSCO, 2003).

92. Prohibited activities usually include trading in securities (including derivatives) while in possession of material non-public information pertaining to the underlying security, and communicating inside information (tipping). While primary tipping (i.e. tipping by primary insiders) is prohibited in most jurisdictions, there appears to be less of a regulatory consensus with regards to secondary tipping (i.e. tipping by secondary insiders). The best practice, however, suggests, that sanctions be provided against both primary and secondary tipping (IOSCO, 2003:11).

93. In some jurisdictions, intent is a necessary condition for insider trading to represent an offence, while in others, it is not. IOSCO’s report (2003) does not call for a proof of intent to necessarily be made part of regulatory policies.

94. Supervisory activity or a regulatory authority with respect to insider trading, typically consists of collection of information concerning suspicious transactions, the identification of the parties to suspicious transactions, an analysis of the previous activity of identified investors, the identification of persons who had access, or could have had access to, inside information; and an analysis of relations between persons who had, or could have had access to, inside information or to the parties to suspicious transactions. (IOSCO, 2003: 15). If a regulator’s inquiry reveals that an insider transaction has occurred, it may launch an administrative or civil proceedings, or notify the public prosecutor if criminal penalty is previewed and the regulator concludes it to be applicable.

95. In the exercise of their functions with respect to insider trading, regulators are usually granted the power to request information from individuals with access to insider information, issuers of publicly traded securities, broker/trader organizations, exchanges and clearing houses. Although there are exceptions, it is not common for regulators to have the authority to search premises, freeze assets or tap phones. (IOSCO, 2003)

96. Sanctions for insider trading fall into either of the three categories: civil, administrative, or penal. In most jurisdictions it is possible to present more than one type of sanctions, but this is fairly uncommon in practice. Regulators are either given the discretion over the choice of the appropriate kind of sanctions,
or required to follow a formal criteria in that choice. There is an international trend towards a greater use of administrative sanctions as the most effective means for deterring insider trading. Although less severe than penal sanctions, administrative sanctions involve less burden of proof and can be imposed swiftly. In case of individuals, these usually include disgorgement of all profit made on the illegal transaction(s), a fine up to a certain amount, and a temporary disqualification from occupying management roles. Yet another advantage of the administrative sanctions is that they can be imposed on legal persons for failure to provide necessary discipline and supervision in dealing with insider information. (IOSCO, 2003)

97. **Issuers’ responsibilities** with respect to insider information usually include an obligation to provide timely public disclosure of information that may have an impact on the price of traded securities, creation of rules and procedures that restrict access to sensitive information within the organization to those individuals that have legitimate need to use it, disclosure of insiders’ trades, and restrictions of trading activity by insiders for a certain period prior to release of periodic results. If there are indications that someone in the marketplace is trading on the inside information, it is issuers’ responsibility to make such information public immediately, so that all market participants could account for it in their investment decisions. (IOSCO, 2003)

3. **Russian Case – The Existing and Evolving Regulations Regarding Insider Trading and Market Manipulation**

98. While several elements of insider trading regulation was present in Russia since mid-nineties, a holistic framework was vividly missing, and enforcement was deemed inadequate. The passing of the Federal Law #224 ‘On Insider Trading and Market Manipulation’ on 27 July 2010 was intended to address the remaining gaps in regulatory framework and give a boost to enforcement.

99. This law came in effect in January 2011, yet the reporting obligations of issuers and other entities were postponed until the beginning of 2012. In addition, sections of the Law that preview penal sanctions enter effect only on 31 July 2013.

100. The law provides a definition of insider information that includes most elements seen in other jurisdictions – such as confidentiality and materiality, but also requires that the information be specific and precise. However, the definition adds one conditional element which is quite unusual in the international practice: to have an insider status, the information must conform to one of the types mentioned in the regulator’s exhaustive list of material events. Separate lists are presented for specific entities, including issuers, exchanges, rating agencies, etc.

101. Although there have been precedents in other jurisdictions where the regulator would issue a catalogue of events that must always been considered material (Malaysia is one example), we are not aware of such lists being exclusive – and particularly, of them being placed above the principle.

102. We further note that the definition presented in the law addresses not only the securities, but also commodities and currencies.

103. The Law does not distinguish between primary and secondary insiders, but typically makes a reference to the specific role or function of the insider in question. Significant shareholders with stakes over 25% are treated as insiders regardless of actual access to information.

104. The Law forbids trading on the basis of inside information, as well as tipping and market manipulation. However, it does not introduce formal ‘blackout’ periods, such as a certain period of time prior to an earnings announcement, where corporate insiders would not be allowed to trade.
105. The Law requires that issuers maintain lists of insiders and submit them to organized exchanges on which their securities are traded. Issuers must comply with the regulator’s procedures for public disclosure of material information, develop internal procedures for treatment of inside information and related compliance procedures. Corporate insiders must inform issuers and the regulator of all trades in issuer’s securities and positions in derivative contracts.

106. Administrative sanctions for insider trading violations are fairly modest: up to Rb 5,000 for individuals, up to Rb. 50,000 for those in position of authority, and up to Rb 700,000 for legal persons.

4. Russian Insider Trading Regulations Vis-à-Vis Other Markets

107. With the passing of the long-awaited Insider Trading Law in 2010, several basic definitions, principles, and prohibitions pertaining to insider trading and market manipulation present in most other jurisdictions were introduced in Russian Law.

108. The definition of inside information in the new Law is unusual in that it requires such information to correspond to one of the types cited in the regulator’s list. The exhaustive, rule-based approach creates risks that certain types of material information may be left outside the scope of events covered by the Law.

109. Enforcement is untested. Issuers’ reporting obligations that provide necessary inputs for identification of suspicious trades came into force only in January 2012. There are no precedents for the exchanges or intermediaries playing their role in exposing informed trades or market manipulation.

5. Conclusions

110. The primary goal of all insider trading regulations is to achieve higher liquidity and lower cost of capital to issuers through more effective and fair functioning of financial markets. There have been numerous examples of countries, particularly in the emerging world, passing insider trading laws, but not enforcing them. Bhattacharaya and Daouk (2002) surveyed 103 markets and found insider trading laws in 87 of them. However, only 38 had enforcement procedures in place, as evidenced by prosecutions.

111. Not only does the approach of passing the insider trading law and failing to enforce it fall short of achieving the primary goal of the regulation in stimulating the development of financial markets, but it may also have a net negative effect. Bhattacharaya and Daouk (2002) found that in itself, the passing of insider trading laws does not lead to lower costs of capital; that effect is observed only when enforcement becomes visible. Moreover, in a subsequent work (2009), these same authors found that the cost of equity actually rises when countries enact an insider trading law but do not enforce it.

112. These observations on the experience of other markets present an important lesson for policy-making in Russia. Most of all, that all the efforts undertaken so far to create a legal infrastructure for countering insider trading and market manipulation are worthwhile only if followed on by competent enforcement.

113. Risks to effective enforcement may include the rule-based definition of inside information under the existing regulation, modest administrative sanctions, and limited experience of courts in imposing penal sanctions related to insider trading and market manipulation (when these come into force in 2013).
References


