

Capital Markets Monitor



May/Sept 2003

**Financial Attaché's Office
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CORPORATE GOVERNANCE UPDATE

IPA holds onto shrinking number of minority-shareholder board positions

The Investor Protection Association (IPA) announced the results of elections to the Boards of Directors (BoDs) after this year's round of AGMs (Annual General Shareholders' Meeting). Fifty-six candidates nominated by the IPA will work on BoDs, 42 will be representatives of minority shareholders, and 14 will be independent directors. While the election results for the BoDs is proportionally higher than last year (when 55 out of 74 candidates were selected), the unfortunate truth is that there will be 18 fewer IPA reps on the BoDs in Russian this coming year.

Association representatives were elected to the BoDs of 37 companies, out of a total of 44 firms proposed. Of the 37, 25 represent the energy sector and 8 are from the communications sector, reflecting the market preferences of IPA's changing membership which now includes brokers and holders rather than simply portfolio investors. The decrease in the number of companies is likely due to consolidation in the communications sector as a result of the restructuring of Svyazinvest, in which the number of regional subsidiaries decreased to seven. The number of such minority positions fell in the energy sector as well, due to consolidation of blocks of shares by strategic investors, resulting in a decrease in the number of portfolio investors in energy companies. For instance, the massive purchase of RAO UES shares by BasEl and MDM allowed them to consolidate around 8% of the company's shares and get three seats on the BoD, while portfolio investors got only one seat instead of the three they held last year. Also, the Association employed a new technique to attract votes by cooperating with U.S. investment companies that hold ADRs for their clients. The SEC requires such companies to vote for their clients and this year, some investment companies supported IPA candidates on the elections. Although the short-term result is not ideal, the inevitable prospect of future IPOs will reverse this trend as independent directors on the BoDs are necessary to list shares abroad.

May - September 2003

Standard&Poor's 2003 Transparency Survey - Modest Improvements

Corporate disclosure has always been a problem in Russia. The S&P rating agency issued its first transparency ratings of Russian companies in 2002. Recently, S&P upgraded and expanded these rankings to include 60 firms. It restricted its findings to cover only publicly-disclosed information, with, for the first time, the cooperation and support of MICEX. This year's ratings showed some improvement compared to 2002, with the average level of transparency increasing from 34% to 39%. The study showed that 31 companies were able to increase the disclosure level by 9% on average, while 10 companies were downgraded by an average of 5%. Transparency improved most significantly in Volgatelecom, Rostelecom, South Telecommunication Company, Gazprom, Uralsvyazinform, Norilsk Nickel and Vympelcom. Topping the list in 2003 was Wimm-Bill-Dann, earning 85% of the total transparency points. Despite the positive news for some firms, the study showed that transparency is improving only at a modest pace. Increased corporate disclosure seemed to occur in companies which were ranked in the mid or above mid-range last year, while the bottom 20% showed absolutely no change. Market participants urged the FCSM to tighten disclosure requirements and increase enforcement for non-compliance.

REGULATORY UPDATE

FCSM strives to lower the volume of investment companies' veksel programs

Brokers' veksel are short-term promissory notes. They are non-issuance instruments, are not widespread and are not considered market paper in Russia. However, some companies still use veksel programs for cash management. For instance, Troika Dialog had 35 veksel programs for this purpose. However, in many cases, brokers issue veksel for their clients to mask larger problems of liquidity, transferring all commercial risk to the holders of such instruments. Although the FCSM cannot by law prohibit companies from issuing veksel, it has begun to introduce regulatory and normative changes to make it harder for companies to issue them. A separate but related issue is a simplified registration procedure for short-term bonds with terms of three months or less. This would reduce the paperwork and time needed to register sales and trading in these instruments, which would provide a market-based alternative to issuing veksel. Although the idea was first raised several years ago, the FCSM is still considering how to implement it.

Stock options for banks

The Central Bank has amended the instruction "On the rules of issuance and registration of the shares of banks," detailing the mechanism for the issuance of options on banks' shares. Bankers reacted positively to the news, as it will facilitate an increase in banks' capitalization. The new rules are applicable only to banks whose shares trade on the market. There are two ways of placement allowed: either on the open market or among the employees of the bank. Open market placement would be difficult at this time, as there are few banks with shares in circulation. The second alternative could have more impact on

bank capitalization by linking management interests to those of shareholders by creating incentives for good managerial performance.

At the same time, the CBR amendment strengthens the rules of information disclosure. This was proposed in order to reconcile CBR regulations with the amended law "On the Securities Market." Banks now have to provide the CBR with information on their financial and economic status over the past five years. Prospectuses for a new share issuance should include consolidated financial reporting (including subsidiaries) for the last three years, and must be signed either by the financial consultant or an independent appraiser. (The former is a special role created by Russian legislation that signs prospectuses and takes responsibility for their accuracy, functions generally performed by an investment bank issuing securities in the West.) Even though the newly amended instruction tightens the requirement on information disclosure, many banks reacted positively, as it should reduce their reporting burden. The new requirements should also decrease risks for future investors, which in turn could reduce borrowing costs.

Mergers and Acquisitions: Protection of Shareholders' Rights

Currently, the law "On Joint Stock Companies (JSC)" contains a vague provision that states that in cases of a purchase of more than 30% of a firm's shares, the potential buyer has to make an offer to buy the shares from the rest of the shareholders. However, the JSC law also allows this provision to be waived if the shareholders agree in a shareholders' meeting to do so. The FCSM has developed a set of the amendments to the JSC law and to the law "On Securities Market" which lowers the percentage of shares that triggers this requirement to 25%. The Commission has also proposed to specify detailed procedures for takeovers including: purchase offer; review and approval by shareholders; evaluation of share price; and share transfer. Some market participants were skeptical of this idea, noting that clarity in the process will be difficult to achieve in practice; for example, anonymous buyers can purchase shares in smaller blocks using a variety of offshore structures. However, such an owner may need to reveal his identity if the company in the future issues bonds, undertakes an IPO, or borrows money overseas. The Ministry of Antimonopoly could then step in and sue the owner in court, which would void the merger. The proposed amendments are currently being discussed at the inter-ministerial level. At the same time, the Ministry of Economic Development and Trade (MEDT) is researching corporate takeover practices in Russia. Based on the results of this research, MEDT will make its own proposals for amendments.

CAPITAL MARKET EVENTS

New RTS

The conflict between the FCSM and RTS concerning the separation of direct and indirect transactions has been successfully resolved and the Commission approved new rules for the stock exchange in June. The conflict arose at the beginning of the year and concerned the exchange's practice of not separating direct (i.e. negotiated) from indirect transactions when

calculating trade volumes and indexes. (See CMM for Feb/April 2003.) It took several months for the RTS to satisfy the demands of the Commission, but now the two types of transactions are separated in RTS statistics. Only indirect transactions are included in volumes, while the information about direct transactions can still be viewed on the RTS website. The new rules had no effect on the mechanics of trading, possibly due to the fact that resolution of the conflict brings more transparency and reduces uncertainty for market participants.

Vladislav Streltsov was, unsurprisingly, elected as the President of the RTS at the annual members meeting (he had been acting since the resignation of Ivan Tyryshkin.) A third of the Board of Directors was replaced as well. Dmitriy Ponomarev returned to the BoD of the stock exchange in the position of Chairman; he held this position from 2000-2002. During the annual meeting, Streltsov announced the exchange's recent plans to attract trading in corporate bonds, Eurobonds and repo transactions that are currently done off the exchange. The ultimate goal of the RTS is to increase its competitiveness and attempt to catch up with MICEX, which is currently the leading Russian stock exchange in terms of volume.

MICEX fights for trade in Gazprom shares

Over the summer, MICEX appealed to Prime Minister Kasyanov to consider its proposal to trade Gazprom shares. Currently, only four stock exchanges have permission to do this, including the Moscow Stock Exchange, the stock exchange "St. Petersburg", the Ekaterinburg stock exchange and the Siberian stock exchange. The MICEX proposal, developed some time ago, would be for MICEX to cooperate with the Moscow Stock Exchange and Ekaterinburg Stock Exchanges, who would organize actual trading, while MICEX would provide clearing functions and serve as a technical center. However, the Central Bank (one of the biggest shareholders of MICEX) does not favor the proposal, presumably due to hidden trading risks that the CBR believes should be analyzed more closely. The CBR therefore requested that the arrangement be postponed. Not surprisingly, the FCSM accused the CBR of exceeding its authority by intervening in capital market regulation, giving rise to yet a new conflict between the two entities. MICEX also plans to appeal to the President, the FCSM and Gazprom itself. Over the summer, the RTS solved a similar problem by simply signing an agreement with the stock exchange of St. Petersburg. Another possibility which MICEX was considering was purchasing the Moscow Stock Exchange, which effectively monopolizes trade in Gazprom shares – an average of 95-97% of its volumes are trading Gazprom shares.

THE RUSSIAN STOCK MARKET IN MAY- SEPTEMBER 2003

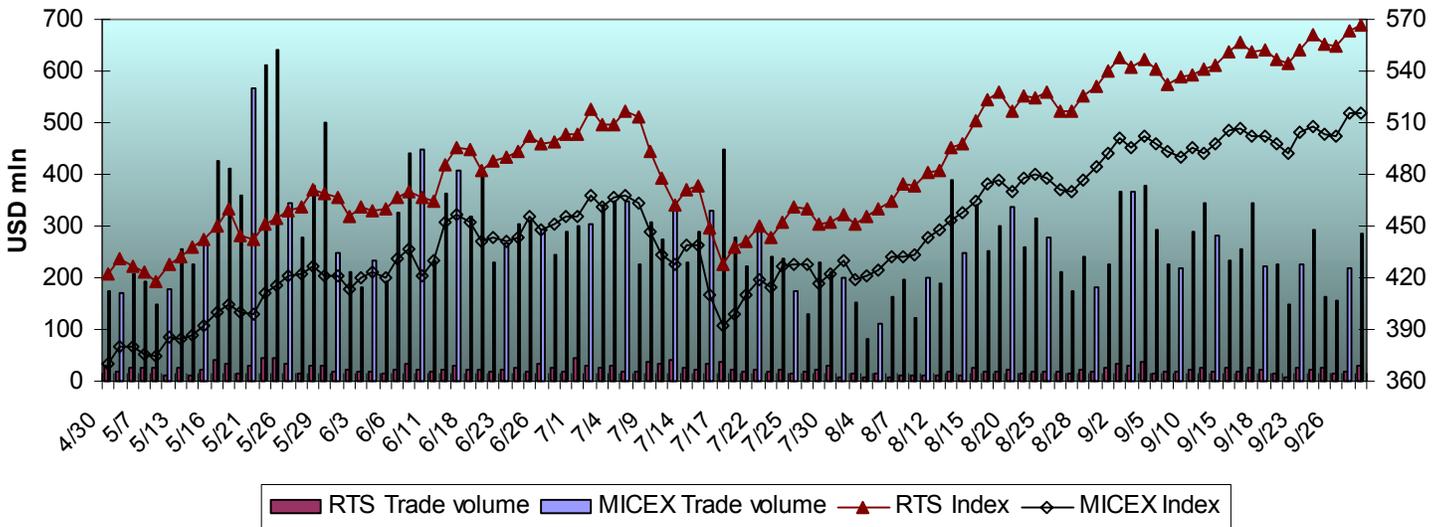
The Russian stock market experienced a considerable growth throughout May, June and the beginning of July. Although the rise was interrupted by modest downward corrections and periods of consolidation, the upward trend was very strong overall. The RTS index pierced through the important level of 500 and peaked at 518 on July 2, 2003. The last time the market saw such levels were six years ago, in October of 1997, right before the beginning of the Asian financial crisis. RAO UES shares (both preferreds and common) were among the

leaders of growth during this most recent bull run. Gazprom shares were up as well, on strong volumes. Shares of the gas monopolist were considered to be relatively undervalued since the beginning of the year, which explains the recent growth in Gazprom's capitalization. Rumors of the upcoming trade in Gazprom shares on MICEX also fueled prices.

However, the week of July 7 was a disaster for the market. Traditionally, the stock market falls after July 4, but this year the trend was greatly exacerbated by the investigations into YUKOS and Sibneft. This unexpected event caused traders to dump these shares, which had been among the leaders of growth until the end of June. Selling then spread to other oil shares and then to the rest of the market. The correction was quite deep - the RTS index was down by 9.21% for the week, while Sibneft and YUKOS shares lost 18% and 13.3% for the same period. The next week, the market unsuccessfully tried to stop slipping, but news that the rating agencies might not increase Russia's sovereign rating soon sent the market tumbling further. Non-resident investors were the main selling triggers that second week, which triggered further domestic sales. Good domestic corporate news as well as a favorable atmosphere on world markets was mostly overwhelmed by the uncertainty over the length and scope of the YUKOS affair. There were some exceptions: Norilsk Nickel, for example, did quite well compared to the market due to higher prices of nickel on the world market. When share prices fell to attractive enough levels to become "buy" candidates, the trend was reversed for the third week in July. However, in the following week the market fell again on the rumors about possible criminal cases against Sibneft management. By the end of July, the market index reverted back to its level at the end of May.

However, the situation improved dramatically over August and September. The RTS index rose 23.98% in 8 weeks starting from August 1. YUKOS and Sibneft shares partially recovered, with all oil shares supporting market until the middle of September, when the world oil prices dropped. In addition, RAO UES, supported by strategic investors, and MMC Norilsk Nickel also buoyed the growing stock index. Trade volumes were slow during the August holiday period but moved to above average levels in the beginning of September. The market recovery also spread to a number of second-tier stocks as well. The RTS index reached 6-year highs near the end of September and by the first day of October it reached a historic maximum of 573.85. (The highest previous level of 571.66 was achieved in October 1997.) Since the beginning of the year the RTS index gained 57.8%.

RTS and MICEX in May-Spt.'03



Explanatory notes

ADR - American Depository Receipt

AGM – Annual shareholders’ meeting

ARM - Association of Russian Managers

CBR – Central Bank of Russia

DCC - Depository Clearing Company

EGT – Extraordinary Shareholders’ meeting

FCSM – Federal Commission on Securities Market

GDR - Global Depository Receipt

ICLG - Institute of Corporate Law and Governance

IPA - Investors' Protection Association

MICEX - Moscow Interbank Currency Exchange

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NAUFOR - National Association of the Capital Market Participants

NFA - National Capital Market Association

PARTAD - Professional Association of Registrars, Transfer Agents and Depositories

RTS - Stock Exchange "Russian Trading System"

SGQ - RTS System of Guaranteed Quotes

MMC Norilsk Nickel - Mining & Minerals Company Norilsk Nickel

If you have further questions please contact Maria Golovnia at: golovnyam@state.gov
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