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**PROTECTION OF INVESTORS:  
NEW CHALLENGES FOR THE  
DISCLOSURE OF INFORMATION  
IN THE SECURITIES MARKET IN  
RUSSIA**

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## **PROTECTION OF INVESTORS: NEW CHALLENGES FOR THE DISCLOSURE OF INFORMATION IN THE SECURITIES MARKET IN RUSSIA<sup>2</sup>**

The disproportion of information in the stock market creates conditions for unlawful use of insider information, which, in turn, produces a negative impact on the stock market, investment conditions in the country and the economy as a whole. In Russia the institute of disclosure in the securities market does not secure provision of investor rights to obtain quality information on the issuer of securities, its group of entities, its financial conditions, as well as other important aspects, which are of principal significance for the issuer and its affiliated parties. Information disclosed by the issuer is not reliable for investors. Only a few pay attention to the disclosure of information, such information is not analysed and is hardly monitored by the regulator with regard to the obligation to report it. Issuers have no incentives to disclose information, as mechanisms of liability are ineffective. This institution in Russia does not mitigate the disproportion of information between insiders and outsiders. It leads to considerable costs for the issuers, while the level of investor protection is not increased. The rights of investors in the securities market are not protected. The whole system of the disclosure of information requires reasonable and systematic restructuring.

An obligation for issuers to disclose information in good faith should be stipulated. It is necessary to abandon the attempt to foresee in legislation all possible important events, the details of which can affect investment decisions. Disclosure should be timely, correct, reliable, consistent, concise, and free from irrelevant information.

A reconsideration of the system of liability for unfair disclosure is required. The CEO of the issuer shall be liable for proper disclosure. It is reasonable to consider the burden of proof of good-faith disclosure on the CEO.

It is important to change the approaches to the administrative liability of the issuer (in violation of the rules of the disclosing of information fault must be presumed, lack of fault must be proved by the issuer; the statute of limitations for imposition of liability should be increased since detection of the violation within one year is often impossible).

JEL Classification Z

**KEY WORDS:** the disclosure of information by issuers, protection of investor rights, legally relevant facts and disclosure of information on the securities market, duty of disclosure in the securities market, proportionality violations and penalties.

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## Introduction<sup>3</sup>

The disclosure of information by issuers is one of the most important elements in the securities market. An investor who decides to buy, sell or hold the issuer's securities should be informed about the issuer's company, group, financial situation and other meaningful aspects of their activity and related matters. This information is disclosed to the individuals of the company (directors, governance of the company, majority shareholders, employees), to the state authorities and to others (in particular, to consulting firms, law firms, auditors) which provide services to the issuer and have access to important information.

The disproportion of information in the securities market creates conditions for unlawful use of insider information, which has a negative impact on the stock market, investment conditions of the country and the economy as a whole.

The lack of mechanisms aimed at protecting investor interests results in the infringement of public interest as capital markets cannot be effectively developed, which leads to a deceleration of capital flow.

Some market participants—the issuer and its affiliated parties—may have preferences as opposed to other participants, especially investors<sup>4</sup>.

All modern systems of law recognize that making use of these preferences cannot be considered fair, therefore the weaker parties (primarily, investors) shall have remedies to ensure protection of their rights.

Disclosure of information as an obligation imposed on the issuer and its affiliated parties shall mitigate this disproportion.

Disclosure means that the issuers of securities shall publish material information for general access in accordance with the applicable legislation. Investors, potential investors, issuer employees, state authorities, other interested persons can get this information. Based on this information these persons are able to analyse the issuer's financial situation, prospects, to compare the issuer's activity with the activity of its competitors and the issuer's activity in other fields of business, to assess risks and make other decisions with regard to the issuer and its securities.

In Russia, the institute of disclosure of information originated from the USA. For the first time the need for disclosure of information was raised by the American judge Louise D.

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<sup>4</sup> On the information disproportion see: Consumer protection of the financial services / M.D. Efremova, V.S. Rumyansev and others. Resp.editor Y.B. Fogelson. – M.: Norma, Infra-M, 2010.

Brandeis in his book “Other People’s Money and How the Bankers Use It”<sup>5</sup>, published in 1914. However, this idea was implemented only in 1929 after the financial crisis in the form of the Securities Act of 1933 and aimed to protect investors against fraud by the issuers.

Along with the USA, disclosure of information is actively promoted by the OECD which recommends ensuring an operative and accurate mechanism of disclosure of information as an instrument of effective corporate governance<sup>6</sup>. According to the OECD Principles of the Corporate Governance a strict regime of information disclosure shall encourage investment of capital and maintain investor confidence. Insufficient and inaccurate information can aggravate market operation and increase the capital value and lead to abnormal resource allocation.

In Russia disclosure of quality information in the securities market does not secure the provision of investors with information on the issuer of the securities, its group of entities, its financial conditions, and other important aspects, which are of principal significance for the issuer and its affiliated parties. Information disclosed by the issuer is not reliable for the investors.

This institution in Russia does not mitigate the disproportion of information between insiders and outsiders. It leads to considerable costs for the issuers, while the level of investor protection is not increased. The rights of investors on the securities market are not protected.

Many studies and reports have noted that poor legislation on the securities market causes damage to economy and businesses, it discourages companies from entering the public market and causes damage to innovations, entrepreneurship and economic growth<sup>7</sup>.

The whole system of disclosure of information in Russia requires reasonable and systematic restructuring.

There should be an obligation for issuers to disclose information in good faith. It is necessary to abandon the attempt to foresee in legislation all possible important events, the details of which can affect investment decisions. Disclosure should be timely, correct, reliable, consistent, concise, free from irrelevant information.

It is important to consider the who, and based on which criteria will be assessing the good faith in disclosure of information. There should be established a standard of good faith for this disclosure.

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<sup>5</sup> New York, NY: Stokes, 1914.

<sup>6</sup> Official cite OECD [Electronic resource]: OECD Principles of the Corporate Governance. <http://www.oecd.org/daf/ca/corporategovernanceprinciples/32159669.pdf>.

<sup>7</sup> Rene M. Stulz’ Securities Laws, Disclosure, and National Capital Markets in the Age of Financial Globalization Journal of Accounting Research Vol. 47 No. 2 May 2009 DOI:

It seems obvious that a mistake in the issuer's bank details specified in the quarterly report, is incomparably less significant in comparison with the failure to provide information on the revocation of the audit reports which confirmed the fairness of the issuer's financial statements for the last two years. Accordingly, these two infringements should be punished differently.

The system of liability for unfair disclosure needs to be reconsidered. The CEO of the issuer shall be liable for proper disclosure. It is reasonable to consider the question of imposing of the burden of proof of good-faith disclosure on the CEO.

For example, in the USA, the director who violated the obligation to disclose information, risks to be imprisoned.

It is important to change some of the approaches to administrative liability of the issuer:

- with regard to necessity to prove fault in violation of the rules of disclosure; fault must be presumed; lack of fault must be proved by the issuer;
- the statute of limitations for the imposition of liability should be increased as the detection of the violation within one year is often impossible, whereas its social influence is large.

To create new, comprehensive rules for disclosure of information on the securities market, it is useful to take into consideration the developments of international organizations (for example, Principles for financial market infrastructure of the Committee on Payment and Settlement Systems Technical Committee of the International Organization of Securities Commissions (IOSCO), published in April 2012<sup>8</sup>; Principles for financial market infrastructure: Disclosure framework and Assessment methodology of the Committee on Payment and Settlement Systems Board of the International Organization of Securities Commissions, published in December 2012<sup>9</sup>; The Transparency for Listed Companies Directive 2004/109/EC<sup>10</sup>).

## **1. The term “disclosure” and related concepts**

Art. 30 of Federal Law “On the Securities Market” dated 22 April 1996 No. 39-FZ (the Securities Law) defines the following basic terms:

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<sup>8</sup> <http://www.bis.org/publ/CPSS101a.pdf>

<sup>9</sup> <http://www.bis.org/publ/cpss106.pdf>

<sup>10</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:390:0038:0038:EN:PDF>

*The disclosure of information* means the provision of access to information for interested persons regardless of their aims with regard to such information in accordance with procedures which shall ensure the finding and receipt of such information;

*Disclosed information* means the information with regard to which there were performed actions aimed at its disclosure.

The Securities Law lays emphasis on the requirement that the publication of information should be made in a particular order (the procedural aspect) and not on the contents of information itself.

Disclosure can be mandatory or voluntary. Any person has the right to publish information treated by this person as important (such as the conclusion of a major contract). This public reporting is limited by the legal framework which forbids unfair advertisement, illegal distribution of data etc. Some entities are obliged to publish information in order and to the extent prescribed by law (e. g. Art. 92 of the Federal Law “On the Joint-Stock Companies” dated 26 December 1995 No. 208-FZ (the JSC Law)).

Disclosure of information in the USA is different. There is no legal definition of disclosure of information. However, the Securities Act of 1993 is based on the ultimate principle that issuers are required to disclose in full all material information which may be useful for reasonable investors to take an independent decision. As “material” is considered information, the non-providing or misrepresentation of which may influence the economic decisions made by the users of such information.

Moreover, the Securities Law introduces the term “generally accessible” which is information which does not require any preferences to get access to or is subject to disclosure under the Securities Law (e.g. articles, interviews and other materials published in the media or on the Internet).

The difference between “disclosed” and “generally accessible” information is obvious:

- disclosed information derives from responsible persons, whereas generally accessible information may derive from any person;
- information is deemed as disclosed only if it is published in full according to established procedure. Generally accessible information can be published in any manner.

Along with the terms “the disclosure of information” and “generally accessible information” the legislation defines the term “the provision of information” which means actions aimed at obtaining information by particular persons under applicable securities regulations in

Russia<sup>11</sup>. This means the provision of information by a joint-stock company to its shareholders (Art. 89. 91 of JSC Law) and the provision of lists of shareholders by the registrar and depositor from the shareholders' register (Art. 7, 8 and etc. of Securities Law).

It is not difficult to derive the real difference between the “disclosed” and “provided” information. Disclosed information is available to everybody, provided information is granted to authorized persons and to persons who have requested and obtained information in particular order.

## **2. The importance of disclosure of information**

Recently the disclosure of information has become more important, which has resulted in the large-scale amendment of securities and corporate legislation: a number of essential legal procedures now depend on disclosure of information.

This paper looks at several aspects which are closely linked to legal consequences.

First, disclosure of information is aimed at the exclusion of discrimination among investors in the securities market. Disclosure serves to protect investors' interests, including measures against the unlawful use of insider information.

Second, disclosure solves important problems concerning the efficiency of corporate governance.

Third, statements published within the framework of disclosure of information are considered in Russian legislation as legally relevant information.

### ***The role of disclosure for payments on securities***

The Securities Law (art. 7) introduced new rules on depository's obligation to make payments to its deponents. It is stipulated that the depository shall transfer payments on securities to its deponents within time limits set by law, where as such a time limit shall start as of the date on which the depository holding centralized storage of securities has disclosed information on the performance of payment on securities.

### ***The importance of disclosure of information with regard to bonds***

In some issuer decisions on the issuance of bonds, the bondholder right to claim early repayment depends on the disclosure of information.

For example, the owners of exchange percentage bonds BO-02 “Regional generating company No. 2” open-joint stock company have a right to claim early repayment on bonds

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<sup>11</sup> Article 2 Federal Law “ On the combating to the unlawful using of insider information and marketing manipulating and amendments to the separate acts of Russian Federation” (the Inside Law).

within 30 days from the date of the issuer's disclosure in the newsletter of information on delisting of the bonds<sup>12</sup>.

Moreover from July 1<sup>st</sup> 2014 new rules for the circulation of bonds with regard to prior repayment and the acquisition of bonds by its issuer came into force. From July 1<sup>st</sup>, 2016, every issue of bonds must contain information on the trustee<sup>13</sup>.

It is established that bondholders can demand early repayment within 15 days from the date of disclosure by the issuer of information on accrual of such right, whereas the issuer shall repay the bonds within seven days after expiration of this term. If this information is not disclosed within 3 days, the bondholders can claim early repayment and issuer is obliged to make the repayment no later than seven days of the date of receipt of the claim.

If the terms and conditions of the bond issue set forth the issuer's obligation to acquire bonds from the bondholders under certain conditions, then the issuer shall disclose information on the planned acquisition no later than seven business days prior to the beginning of the term of the acquisition.

The most interesting rule concerns the trustee (the representative of bondholders). It is provided that in some cases the issuer of bonds shall replace the trustee nominated in the issue documentation. If the issuer has not nominated the new trustee within 60 days of the date of occurrence of the respective circumstances, the bondholders shall be entitled to demand early repayment. However, this right ceases after disclosure by the issuer of information on the appointment of the new trustee.

### ***Disclosure of information and insider information***

Disclosure is closely related to the laws on insider information.

*Insider information* is material non-public commercial and official information of the company or economy sector, disclosure of which may impact the market value of financial instruments (including securities of a company or group of companies), goods, currency, other objects circulating in financial markets.<sup>14</sup>

Issuers (which are insiders as per clause 1 art. 4 of the Insider Law) shall transfer the list of insiders to the Bank of Russia at its request as well as to stock exchange institutes and other trade organizers through which are performed transactions with financial instruments, foreign currency and goods (art. 9 of Insider Law). Detailed procedure of how this obligation should be performed is stated in the Regulation on the transfer of the list of insiders to the trade organizers which

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<sup>12</sup> See clause 9.5.1 of the decision on issuance of shares of the "Regional generating company No. 2"

<sup>13</sup> Federal Law "On amendments to the Federal Law "On the securities" and to the separate acts of Russian Federation". On the representative of the bondholders see: A. Selivanovsky., M. Selivanovskaya Representative of the bond holders: Who does it need?// Khozyaistvo I pravo. 2013. No. 11. P. 43-53.

<sup>14</sup> The term "insider information" used in Article 2 of Insider Law. See also A. Selivanivsky, B. Tatlibaev Unlawful use of insider information in Russian Federation: problems of efficiency of regulation// Khozyaistvo I pravo. 2014 No.1.P.35-60.



carryout operations with financial instruments, foreign currency and/or goods, approved by the Federal Service for Financial Markets of the Russian Federation dated May 18<sup>th</sup>, 2013, No. 13-51/PZ-N (the Regulation on insider list transfer).

This Regulation prescribes that in order to control non-ordinary transactions (stock exchange applications)<sup>15</sup> for the purpose of potential unlawful use of insider information and market manipulation, the respective trade organizer is entitled to direct to the issuer of securities a written request for the insider list, provided that:

- 1) The securities of such an issuer and/or financial instruments, the price of which depends on such securities, are allowed for exchange at such a trade organizer and/or;
- 2) an application for the obtainment of access to the exchange at such a trade organizer was filed with regard to these securities and/or financial instruments.

The time limit for the performance of the obligation to transfer the insider list to the trade organizer shall not be less than:

- 5 days from the date of receipt of the request (if the trade organizer requested insider lists for the period of ten days or less) or
- 20 days from the date of receipt of the request (if the trader organizer requested insiders list for the period of more than ten days)<sup>16</sup>.

The trade organizer shall specify in its request no less than two alternative modes of transfer of the insider list by the issuer.<sup>17</sup>

The Bank of Russia established the order and the conditions of providing insider information (art. 8 of the Insider Law). The responsible authorities and companies shall disclose or provide insider information on the official internet site no later than the next business day from the moment of its incurrence, unless otherwise provided for by the Federal Law.

Insiders included in the insider list should notify the issuer and the Bank of Russia on all operations performed with securities of this issuer and the concluded agreements on derivative instruments, the price of which depends on such securities (part 1 art. 10 of the Insider Law).

A detailed procedure of the performance of this obligation is stated in the Regulation on the transfer of the insider list to the trade organizer which carries out operations with financial instruments, foreign currency and/or goods, approved by Russian Federal Financial Monitoring

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<sup>15</sup> On stock trading see: A. Selivanovsky. Stock trading//Khozyaistvo I pravo. 2013. No.10. P. 25-37.

<sup>16</sup> Term of obligation for transfer of the insider list of the company to the trade organizer can be prolonged by the trade organizer based on the justified written request of the company, but no longer than for 15 business days (clause 2.4 Regulation on transfer of insider list).

<sup>17</sup> Clause 2.2.6 of Regulation on transfer of the insider list. Even so, as one of the alternative way the transfer of the insider list shall involve direction by means of postal service (by letter with acceptance notification) the list in material form and (or) in electronic form with insider list text of the company format DBF, XLS, or XLSX.

Service (FSFM) dated 18 May 2013 No. 13-51/PZ-N which distinguishes between two types of insiders:

- 1) Insiders responsible for notifying the issuer on executed transactions on their own initiative;
- 2) Insiders responsible for the provision of such information at the request of the Bank of Russia or respective organizations, included on the insider list<sup>18</sup>. The general term for the provision of information is 10 days from the date of the receipt of the enquiry.

Insiders who are very closely linked to the issuers such as its CEOs, members of the Board, internal auditors and others are included in the first group.

#### ***Importance of disclosure of information for corporate matters***

Art.181<sup>4</sup> of Russian Civil Code<sup>19</sup> entered into force on September 1<sup>st</sup> 2013, states the legal grounds on which the decisions of meetings in consistent with the law can be contested. It is stipulated that decisions of meetings can be contested within sixth months of the date on which the person has become aware or should have become aware of such fact but no later than two years from the date on which the information on the adopted decision has become available for the participants of the company. How can this information become available? Obviously, one of the facts confirming that the information has become generally available is disclosure by the issuer of the securities.

#### ***Representations and warranties***

“Representations and warranties” as a new legal category appeared in Russian Civil Code on September 1<sup>st</sup> 2013. It is required that representations, notices, warranties, undertakings or other legally relevant messages, to which the law or a transaction attributes legal consequences for a person, shall become effective for this person at the moment of delivery of the corresponding message to him or to his representative (art.165<sup>1</sup> of the Code)<sup>20</sup>.

There are grounds for classifying messages in the context of disclosure as representations and warranties. The law attributes to disclosure of information by the issuer legal consequences for the investors (e.g. for the bondholders). These consequences shall become effective upon disclosure of the corresponding message in the legally established order.

### **3. Obligation of the issuers to disclose information**

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<sup>18</sup> Clause 2.7 of Regulation on the notification on the operations.

<sup>19</sup> Federal law “On amendments to the part I section 4 and 5 and part 3 art. 1153 of the Russian Civil Code” dated 7 May 2013 No. 100 FZ.

<sup>20</sup> Federal law “On amendments to the part I section 4 and 5 and part 3 art. 1153 of the Russian Civil Code” dated 7 May 2013 No. 100-FZ.

Russian legislation imposes a duty of disclosure of information on most legal entities which issue securities. Requirements to disclose may differ with respect to the type of the company.

Table 1.

<b>Liabe company</b>	<b>Disclosed information</b>	<b>Term to disclose</b>
Open-joint stock company	Annual report, annual financial statements (Art. 92 of Law on Joint-stock companies, clause. 8.2 of the FSFM Order of 04.10.2011 № 11-46/PZ-N "On approval of Regulation on disclosure by the issuers of information on issuable securities" (the "Regulation on disclosure"))	No later than two days after preparing of minutes of the general meeting of the shareholders, which has approved the report.
	Prospectus of securities (clause. 2.4.4 of the Regulation on disclosure).	No later than two days after publishing of information on the state registration of securities issue.
	Notice on the general shareholders meeting (Art. 52 of Law on Joint-stock companies)	As a general rule, no later than twenty days prior to the general meeting of shareholders.
Any issuer of issuable securities	Quarterly financial statements (Art. 30 of the Securities Law)	No later than 45 days from the end of the respective quarter.
	Annual financial statements (clause 7.5 4 of the Regulation on disclosure)	No later than 3 days after preparing of the audit report and no later than 120 days after expiring of the relevant financial year
	Notice on substantial facts (clause 6.3.1 of the Emission standards).	No later than one day in the news line, no later than two days on the Internet website as of occurrence of the substantial fact.

Not only is the issuer obliged to disclose information, but also some of its affiliated companies:

- a shareholder owning five or more percent of the voting stock shall disclose information on person(s) having control over such a shareholder;
- a company under control of the issuer shall disclose information on acquisition or sale of voting stock of the issuer or securities of a foreign issuer certifying rights to voting stock of the issuer;
- a person, acquiring securities of the issuer on the basis of a mandatory or voluntary offer shall disclose information on the contents of the offer.

Russian legislation attempts to consider all possible cases of disclosure of information by the issuer and to impose detailed regulation where and how the information should be disclosed.

This approach can be demonstrated by the list of material facts to be disclosed by the issuer which includes up to 50 items (clause 14 art. 30 Securities Law).

Such an autocratic approach to disclosure of information, however, does not solve the problem of providing investors with important information. Responsible parties disclose a lot of unnecessary information, whereas the real substance is hidden in meaningless flood of repetitive information.

For example in the quarterly report of the issuer there is a section named “Risks, connected with acquisition of placeable issuable securities (usually clause 2.5 of there port) in which are placed general comments on the state, regional, financial, branch, legal risks. This information is repeated by the issuers from report to report without changes.

On the other hand, disclosure of essential data can be avoided.

In January 2011 Apple Inc. announced that Steve Jobs leaves the company for personal health reasons. As a result of the disclosure the share price of Apple Inc. fell by 9% at Frankfurt Exchange and subsequently by 4% at New York exchange. Non-disclosure of this information could have resulted in lawsuits from investors in Apple Inc. For non-disclosure of important information. Pursuant to Russian legislation such information is not subject to disclosure and the issuer would have no concerns about lawsuits from investors<sup>21</sup>.

According to Russian rules the issuer is not obliged to disclose information on litigation proceedings if the sum of demand is less than 10 percent of the balance sheet assets value at the reporting date (quarter, year) preceding the filing of the claim. Disclosure of such information is left to the issuer’s discretion. The patent dispute between Apple Inc. and Samsung would not be subject to mandatory disclosure in Russia. However, the dispute would be important for decision-making and investment.

It is not possible to make a full list of material facts important for the investors. Moreover, the inclusion of such list in the legal requirements would not help investors and as it would enable the issuers to conceal material information by referring to the said list.

NIH, an open-joint stock company, was a major issuer of shares and bonds which traded on the Russian Stock Exchange. NIH as a holding company of the big group of companies prepared consolidated financial statements under IFRS. The financial statements were reviewed by an independent audit firm which confirmed that the consolidated financial statements dated 2006-2008 were represented fairly. However, in the course of conducting another audit the auditor revealed misconduct and unreliable documents.

In April 2009 the audit firm issued a notice to revoke prior reports. The issuer did not disclose this information. This fact was briefly announced in one press release available on the website of the issuer. According to Russian law, the issuer was in compliance with the law, however for the investors the issuer intentionally concealed important information.

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<sup>21</sup> The details are in the chapter responsibility of investor for breaches of disclosure, see the paper

Russian law, as described above, establishes mainly the procedure of disclosure of information for the issuer and his affiliated persons and does not pay attention to the quality of the disclosed information. Such disclosure of information is considered appropriate. However, the law does not impose requirements for timely, fair, consistent, brief information free of irrelevant details. Obviously, the absence of these requirements entails absence of trust for investors.

The prospectus of the NIH issue of shares (signed by the director general and the chief accountant, approved by the board of directors on December 7<sup>th</sup>, 2009, registered by the FSFM in February 2010) included consolidated financial statements of the NIH group prepared in accordance with IRFS. The document included consolidated financial statements for the period of 2006-2008 and the auditor's report confirming the fairness of the corresponding statements. However, the auditor's report was revoked in April 2009. Thus, prospectus contained false information. However, the FSFM, considering a claim from investors form is representation did not find evidence of the issuer's wrongdoing because of the absence of infringement of any direct requirement of the law and FSFM regulations.

Special attention should be paid to the moment when the obligation to disclose appears and when such obligation ceases.

There is an obligation to disclose:

- for any issuer at the beginning of issuing procedures of securities;
- for the open-joint stock companies from the moment of state registration;
- for closed joint-stock companies from the date following the state registration of the issue or additional issue of bonds or other securities with public placement<sup>22</sup>.

The obligation to disclose information ceases stage wise depending on the type of disclosure of information and the company's form of business. The obligation of an open-joint stock company to disclose information in the form of quarterly reports cease sat:

- 1) the adoption of the decision which declares the issue of securities with state registration of prospectus as not taken place or invalid;
- 2) the adoption of the decision which declares invalid the state registration of the prospectus, the registration of which followed the state registration of the issuing report;
- 3) the redemption of all securities with regard to which a prospectus was duly registered. In practice, this ground is the most common reason for the obligation to disclose of information in form of quarterly reporting to cease;

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<sup>22</sup> See clauses 2.1.1, 8.1.2 Regulation on disclosure.

- 4) the release of an open-joint stock company of the obligation to disclose or provide information to the Bank of Russia (previously FSFM) in accordance with the Securities Law (see below).

Financial problems of the issuer (including insolvency) do not relieve the issuer of the obligation to disclose information. Nevertheless once an issuer gets into difficult financial situation, it usually stops disclosing.

For example, NIH got into financial difficulties. The controlling parties decided to divest assets. Within several months all the cash flows from the subsidiaries and borrowers were redirected from NIH to another company. No information was disclosed.

There are cases when the issuer under bankruptcy procedures continues to disclose information, for example, Amurmetal<sup>23</sup>.

## **4. Forms of disclosure of information**

The law and the regulations of FSFM on disclosure information provide for different forms of disclosure of information by open-joint stock companies. The form of disclosure means a type of document in which disclosure should be performed in accordance with the specified procedure.

The variety of forms of disclosure of information is designed to protect investor rights to have access to information on regular basis, when the information disclosed at the end of a certain period and on a non-regular basis when disclosure is due to the occurrence of a certain corporate event.

The forms of periodic disclosure performed by open-joint stock companies are:

- 1) the quarterly report on issuable securities;
- 2) the annual report;
- 3) the annual financial statements (balance sheet, profits and losses statements, annexes to the balance sheet and to profits and losses statements, auditor's report confirming fairness of the balance sheet, clarification statements);
- 4) the consolidated financial statements;
- 5) the list of affiliated companies;
- 6) the bylaws and other internal documents related to corporate governance.

Non-regular forms of disclosure are: issuance documentation (the decision to issue securities, issuance prospectus, notice on material facts which can substantially affect the investor decisions).

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<sup>23</sup> <http://amurmetal.ru/investoram/svedenie-ob-obshchestve.html>

The information which should be reflected in the named documents, the form and order of disclosure of information are set forth in the Regulation on disclosure of information.

All of the documents are signed by the director general of the issuer and the chief accountant, which certifies the fairness of the information. Some of the documents should be approved by an authorized body of the issuer (for example, the annual report of an open-joint stock company is approved by the shareholder sat the AGM).

Let us highlight the major principles of disclosure of information.

### **Quarterly report**

The obligation to disclose information in this form first appears starting with the quarter when the prospectus of issuance was registered.

Quarterly reports generally are not filed with registration authorities (the exception is issuance of mortgage-backed bonds). The text of the quarterly report shall be published on the website not later than 45 days after the end of the quarter and shall be available on the website for 5 years from the date of its publication.

### **Annual and consolidated financial statements**

There are two types of disclosure forms: annual financial statements and interim financial statements.

Annual and consolidated financial statements with regard to the past financial year shall be published on the website with the enclosed auditor's report no later than 3 days after the preparation of the report and no later than 120 days from the end of the financial year.

Interim consolidated financial statements are subject to publication on the website no later than three days after preparation and no later than 60 days from the end of the second quarter of the current year.

### **Notice on material facts**

The issuer is required to promptly disclose information on material events and facts connected with its activity by directing a notice of material facts.

Material facts are considered information, the disclosure of which may have substantial effects on the price of securities and stock exchange quotes.

The Securities Law contains an extensive list of material facts (50 items) which includes:

- 1) the calling and holding of the general meeting of the shareholders and adoption of resolutions;

- 2) the holding of aboard meeting, the agenda and resolved matters including the placement of issuable securities, the purchase of securities placed by issuer, the nomination of executive corporate governance bodies and the early termination of their authorities, the approval of major transactions and interested-party transactions;
- 3) the obtainment of the control over an important company and the occurrence of grounds for the termination of such control
- 4) the occurrence of a person gaining control over the issuer and the occurrence of grounds for the termination of such control;
- 5) acceptance by the arbitration court of a statement of bankruptcy of the issuer, a controlling company, an important company controlled by the issuer, or a person providing security for the bonds.

### **Information on affiliated parties of the company**

Disclosure of information on the affiliated parties is carried out in the form of a list containing information which is known or should be known by the issuer. This list is prepared on the basis of the notification of persons who purchased shares and become affiliated to the issuer.

The list must be published on the website not earlier than the end date of the quarter and not later than two business days of this date. The list should be available for three years from the publication date<sup>24</sup>.

## **5. Means of disclosure**

Regulations require issuers to disclose information strictly by one of particular means. One of such means is publishing announcements in news feeds, in other words, on websites of information agencies which are updated in a real-time. Publishing shall be on the website of at least one of the information agencies authorized to disclose information on the securities market, until 10 a.m. of the last day of the time limit for disclosure of information.

There are five agencies which are authorized to disclose the information of issuers of securities: Closed Joint-Stock Company “AK&M”, Independent non-profit organization “Association for protection of investor’s rights for information”, Closed Joint-Stock Company “Interfax”, Closed Joint-Stock Company “Prime-TASS”, Closed Joint-Stock Company “SCREEN”<sup>25</sup>.

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<sup>24</sup> For details on the form of disclosure of information by the issuers see.: Vavulin D.A Disclosure by the Open-joint stock company”. – M.: Juscticeform, 2012 (text is available in the SPS Consultant Plus; Commentaries to the legislation).

<sup>25</sup> Information from [http://www.openinfo.ffms.ru/as\\_of\\_12\\_February\\_2014](http://www.openinfo.ffms.ru/as_of_12_February_2014)



Issuers, the securities of which are admitted to public trading, shall publish press releases on decisions adopted by the issuer's company governors. Press releases must be published no later than one day following the date of the decision.

In its turn, the issuer, who publishes information on the internet, shall use the page provided by the distributor of information on the securities market. The issuer, whose securities are admitted to public trading, shall additionally use the webpage of the issuer.

The possibility to become familiarised with the disclosed information is secured by the obligation of the issuer to place copies of the document with the disclosed data at the address of the current executive bodies of the issuer and in places specified in the advertising of the issuer.

Copies of the documents are provided at the request of the holders of securities and other interested parties, where as the cost for the receipt of such copy shall not exceed the cost for the copy's preparation. The copies should be provided within 7 days of the date of submission of the request.

### **Exemptions from the obligation to disclose or provide information**

The legislation allows some issuers to be released from the obligation to disclose information<sup>26</sup>. To this end, there should be compliance with the following conditions:

- 1) The issuer has no other issuable securities, except shares, with regard to which there is a registered prospectus;
- 2) The issuer's shares are not admitted to public trading;
- 3) The number of the issuer's shareholders does not exceed 500;
- 4) The general meeting of the shareholders (with  $\frac{3}{4}$  of shareholders participating in the general meeting) adopts a decision to apply to the Bank of Russia with a request for release from the obligation to disclose or provide information;
- 5) The Joint Stock Company applied to the Bank of Russia enclosing the documents confirming compliance with the aforementioned conditions; and
- 6) The Bank of Russia has reviewed the application and enclosed documents and resolved to approve the application due to the absence of false information and unfair data.

The open-joint stock company released by the Bank of Russia from the obligation to disclose information discloses information on this resolution in the form provided for notifications on material facts.

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<sup>26</sup> Article 92.1JSC,30.1 Securities Law.

Information on release of obligation to disclose information is placed for public access on the Bank of Russia (previously FSFM) web page<sup>27</sup>.

The practical application of this procedure reveals the drawbacks entailed by the formal assessment of the possibility for the issuer to be released from the obligation to disclose information. Let us examine a particular example.

The open-joint stock company “Holding Company Milk products for children” (the Holding) in 2007 owned shares of some operational companies which owned real estate, production facilities, selling spaces and were actively engaged into business. The majority of these operational companies disclosed information as they were open joint-stock companies.

The information was disclosed in the prospectus for the issue of shares and the prospectus for the issue of bonds of the Holding which were signed in 2007. Investors analysed the milk business, the business of the production of children’s products and purchased shares and bonds of the Holding. In 2008 the shares of the subsidiaries were transferred to the affiliated company established in the British Virgin Islands (the BVI-company). The Holding owned 98% of shares of the BVI-company. Operational companies kept on disclosing information and investors obtained information on financial situation of the group. However, in May 2011 the operational companies applied to the Russian FSFM for the release of the obligation to disclose information. Based on these strictly formal criteria (indeed, 100% of the operational companies’ shares were in ownership of the sole shareholder—the BVI-company—and the shares and bonds were not publicly traded) FSFM decided to approve the application. The investors were deprived of the possibility to obtain up-to-date information about the activity of the operational companies controlled by the Holding. This made it difficult for investors to take decisions with regard to securities of the Holding.

## **6. Persons responsible for and the checking of disclosure**

The legislation does not stipulate who is responsible for organizing the disclosure of information inside the company. This activity seems to be considered as day-to-day activity of the company. Therefore, under this general rule, responsibility for the disclosure of information lies with the general director of the company (clause 1. art.69 JSC).

This approach is confirmed in judicial practice<sup>28</sup>.

- Executive bodies of the company acting in accordance with the company’s rules on the disclosure of information are responsible for the disclosure of information,

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<sup>27</sup> <http://www.cbr.ru/sbrfr/>

<sup>28</sup> Court decision of FAS Volgo-Vyatskydiscript dated 5 October 2011 No. F01-4279/11 upon decision No. 10996/2010.

- The Board of Directors is responsible for the proper disclosure of information and compliance with the information policy of the company<sup>29</sup>.

When disclosing information, the issuer may for some reason have a mistake in the message or report. Therefore the question of checking the timeliness, completeness and correctness of the disclosure of information is relevant. Information is checked at three levels: at the issuer's level, at the regulator's level, and at the investor level.

At the level of the issuer internal check can be carried out.

For a long time, the issuers were obliged to send to the regulator (FSFM) copies of the quarterly report. Ultimately, it was clear that the regulator has nothing to do with the content of the reports (e.g. review the availability, proper contents of the reports), other than store them. From September 1<sup>st</sup> 2012 issuers were released from this obligation. The regulator has acknowledged its inability to check the information.

For example, at the end of 2011 FSFM imposed a fine on the open-joint stock company "The First Channel" of RUB 9,000,000 for non-disclosure of information on the internet as required by law. The last available quarterly reports were dated 2003<sup>30</sup>.

Most investors (including professional participants of the securities market) monitor the disclosure of information by the issuer badly<sup>31</sup>.

In 2008, the closed joint stock company "Factoring company Eurocommerz" which raised significant funds from bonds stopped making payments on credit and bonds. The company disclosed information on its activities, including financial statements prepared under IFRS. It was revealed that lenders, and the companies and banks which invested in the bonds did not familiarise themselves with the latest financial statements. However, the disclosed information showed the risks of the company and indicated an absence of capital.

## **7. Liability for infringement of obligation to disclose information**

The disclosure of information plays an important role for investors with respect to obtaining information for taking investment decisions and understanding the legal consequences of issue activities.

Logically, one can suppose that disclosure of information is secured by a set of rules establishing negative consequences for the wrongdoers. Russian legislation has borrowed the institute of disclosure of information from the USA, where the law contains severe sanctions for the presentation of false information.

<sup>29</sup> Order of the FKSB of Russia dated 4 April 2002 No. 421/p "On the recommendation to application of the Corporate code of practice" (together with Corporate code of practice dated 5 April 2002).

<sup>30</sup> Details can be found in the article of "Vedomosti" (November 8, 2011 No. 210) or the website

<sup>31</sup> On the reasons of such relation see further

In accordance with Russian law, if a breach of the disclosure obligation occurs, then the violator can be made liable in form of:

- administrative liability for the legal entity (issuer of the securities);
- administrative liability for the officer (usually the director general of the legal entity);
- civil liability for individuals, who have signed and confirmed the quarterly report of the issuer;
- civil liability for the auditor (the individual or company) which prepared audit report for the financial statements of the issuer or the person who provided security for the bonds; and
- criminal liability for the officers.

The threat of criminal liability for the infringement of the obligation to disclose information should stimulate the persons responsible for implementing such rules and proper disclosure of information. The entire regulation base is subordinated to this aim.

However, the practice revealed quite the contrary situation: the only form of liability applied is administrative liability. This could be connected with difficulties in proving the fault of the officer who signed the reports or notices on disclosure or did not secure proper disclosure of information.

### **Administrative liability**

The code of administrative offences provides for several violations in relation to disclosure and the provision of information on the securities market (art. 15,19).

The persons subject to liability are the issuer, its directors, companies under control of the issuer, shareholders of such companies, affiliated persons and persons interested in transactions made by the company.

The corpus delicti are:

- non-provision or non-disclosure of the information required by the legislation;
- a violation of the time limits and order of provision or disclosure of information required by the legislation and adopted regulations;
- the provision or disclosure of incomplete and (or) unfair information, and (or) misleading information.

Considering that the law does not indicate the necessity of presence of negative consequences resulted from the actions or the failure to act of the offender, all the corpus delicti with regard to disclosure of information on the securities market are formal.

For administrative liability to be imposed there shall be proof of the following four elements: the offender, subjective aspect, objective aspect, object (art. 2.1 Administrative Code). Absence of one of the elements excludes liability.

The most complex element is the fault. The fault of an individual is considered as subjective attitude of the person who committed the crime to the fact of the commitment. It is more difficult with the term itself and the criteria of the fault of a legal entity. The grounds for administrative offence in the actions of a legal entity pursuant to the Administrative Code are the following: the fault must result from the legal entity's failure to comply with the legislation, the non-compliance with which entails administrative liability, although the legal entity had the possibility but did not use their best efforts to comply with such legislation. Fault in the form of intention or negligence should be taken into consideration.

This traditional approach functions debatably with respect to the offenses related to disclosure by the issuers.

The open joint-stock company "Nutrinvestholding" did not publish its annual report for 2010 and did not disclose the annual balance sheet as of 31 December 2010, although the company governors prepared and signed the report. The audit company issued an audit report in the form of the refusal of the auditor to opine on the fairness of the data provided. The auditor was not provided with the documents requested by him; moreover he found that the company entered into major transactions and interested-party transactions throughout 2010 without due approval of such transactions. However, the board of directors recommended to the general meeting of the shareholders to approve the annual report with unfair data for 2010. At the annual general meeting the annual report failed to be approved due to the insufficiency of votes. The report was not approved.

FSFM held the control on claim of the shareholder and declared absence of fault in the "Nutrinvestholding" actions. FSFM issued "Nutrinvestholding" an instruction to remedy the violation.

For comparison, there are two examples from US law.

In course of the crisis of 2008 the Bank of America acquired Merrill Lynch. Investors were told that Merrill Lynch would not pay remuneration to its top managers until the closure of the transaction without the Bank of America's consent. In fact, the companies signed a separate agreement on payment of bonus in amount of 12 percent of the total sum of transaction, whereas this fact was not disclosed to more than 283,000 investors. Taking into account the fact that in 2007 and 2008 Merrill Lynch suffered enormous losses, the biggest

losses in the history of the company, and the impact on the global financial situation, the Bank of America was fined by the SEC US\$ 300 million.

In April 2010 the explosion on the Deepwater Horizon<sup>32</sup> oil platform which was owned by BP caused one of the world's largest oil spills in history. BP published three reports in which it considerably reduced (by ten times) the volume of the oil spill in the Gulf of Mexico, and in doing so misled investors. SEC fined BP for disclosure of unfair and misrepresented information. The fine was US\$ 225 million and was the largest in SEC history.

The sanctions for these administrative violations (according to part 2 of art.15.19 Administrative Code) are fines:

- for officials from RUB 30,000 up to RUB 50,000 or disqualification of an individual for up to one year;
- for legal entities from RUB 700,000 up to RUB 1,000,000.

In accordance with the Russian legislation, any violations connected with disclosure in the securities market are not considered publicly dangerous. The wrongdoer may be obliged to pay a fine—if somebody monitors their actions and Bank of Russia renders the relevant decision. Otherwise it is impossible to explain such small fines. In comparison, the minimum value of bonds placed by the issuers in Russia amounts to RUB 1 billion. Thus, the maximal fine of RUB 1 million cannot be compared to any profit gained though misleading and time saving<sup>33</sup>.

Imposing an administrative fine as the result of violation of disclosure is often appealed by the issuer in the arbitration proceedings.

In accordance with the database of “Judicial practice” CPC “Consultant Plus” over the period from January 1<sup>st</sup>, 2005 – March 1<sup>st</sup>, 2014, the number of cases of this category in all districts of Russia is 1072 cases and more than 100 cases at the Higher Arbitrage Court level.

The issuers who appeal the administrative decision in court, refer to the insignificance of the violation (art. 2.9 of the Administrative code). Arbitration courts cancel the decisions of FSFM regarding fines on the issuers on the following grounds:

- 1) FSFM failed to prove the fault of the issuer of the wrongdoer (e.g. the fault of the insolvency administrator, who referred to the absence of the documents and using best efforts for their receipt; technical problems with the website, if taking of reasonable measures by the issuer was proved);
- 2) the arbitration courts rule on the insignificance of the violation without taking into consideration the negligence of the issuer with regard to discharge of his obligations,

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<sup>32</sup> Both cases were borrowed from official site of SEC of the USA [electronic resource]

<sup>33</sup> Lack of sense in existing fines is pointed out by the experts. For example the same position is reflected in the Report “Russia – “Maintenance of reliability and financial sector’s development in Russia” by Group on development of private and financial sectors of European Region and central Asia of a World Bank, published in March 2011.

taking into account the circumstances of the particular case and absence of substantial threat of protected social interests, violations of shareholders rights and other parties, the absence of detriment to interests of the people, society, and the state. Such decisions are made for the late disclosure of the affiliated parties list, or the quarterly report by the issuer by one month, or its non-disclosure.

- 3) violation by FSFM of the procedure for bringing the issuer to responsibility (a failure to notify, or drafting the record in the absence of the authorized representative); and
- 4) the expiration of the statute of limitations (art. 4.5 of the Administrative Code).

### **Civil liability**

The investor comes across two problems which cannot be resolved:

- the lack of an explicit possibility in law to file action for losses caused by the violation of disclosure;
- a factual inability to prove the elements of the violation.

The Securities Law (clause 3 art. 22.1) sets forth that for losses caused to the investor or securities owner due to provision in the report of unfair, uncompleted, misleading information, the following persons are liable jointly and severally:

- persons who confirmed the quarterly report;
- the auditor who prepared the audit report with regard to the financial statements of the issuer;
- the auditor who prepared the audit report with regard to the financial statements of the person which provided security for the bonds.

The same liability is established for the individuals, who signed and approved the securities prospectus.

From these regulations it follows that the investor “as a consumer of the disclosure of information” is not granted the right to claim from the issuer compensation for losses caused by the violation of disclosure of information. If the investor suffers losses, he can apply to the issuer, but surely the application will not be sustained.

Then investor will have to file a court claim with enclosed documents evidencing the elements of the violation. Civil liability demands particular *corpus delicti*: 1) breach of duty, 2) amount of damages, 3) causal relation between breach and damages, 4) fault<sup>34</sup>.

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<sup>34</sup> If the wrongdoer conducts business, the fault is presumed (clause 2 art. 401 Civil Code of Russia).

According to the practice of arbitration courts, the lack of one of these elements shall release the defendant from liability. It is quite difficult to prove a breach of obligation with regard to disclosure of information. Moreover, it is almost impossible to prove the occurrence of losses caused by a breach of the issuer and provide of documented calculation of such losses.

Finding and proving causal link between violation of disclosure of information and incurred damages is even more difficult. The infringement of disclosure of information such as a breach of the order and time limits for disclosure, incomplete disclosure, or unfair or misleading information is not the only possible reason for any loss suffered by the investor. In other words, information disclosed by the issuer does not appear as a decisive factor for the investor's decision making. Therefore, it is not reasonable to speak of the causal relation between a violation of the law and losses suffered.

In the existing legal framework the possibility of imposing liability on persons who signed documents connected with disclosure, approaches zero<sup>35</sup>.

### **Criminal liability**

The line between an administrative infringement and a crime is drawn based on the extent of public danger and the threat to public interests.

The Criminal Code of the Russian Federation was supplemented by two articles, describing crimes connected with disclosure of information in the securities market. However the articles appear as artificial and are not applied in practice.

Russian court practice does not consider infringements related to disclosure as publicly dangerous, and state authorities usually consider such actions as administrative offences under art. 15.19 of the Administrative Code.

In the USA however the offenders of requirements prescribed by securities law bear criminal liability. The Department of Justice and prosecutors are empowered to initiate criminal proceedings. Art. 32 of the Securities Exchange Act of 1934 establishes that the person who intentionally breached any provision of law or intentionally and knowingly published false or misleading data in the report with respect to a material fact is fined up to USD 5 million (for legal entities up to USD 25 million) or imprisonment for up to 20 years. The circumstance which excludes liability is by proving the liable person did not know the applicable regulation; there is a principle that is not applicable in Russia: ignorance of law *is* an excuse.

American specialists confirm the existence of different approaches to the interpretation of intent by the courts: some require specific proof of intent of the person to violate the law, in

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<sup>35</sup> In the base of CPC "Consultant Plus" there are no decisions on recovery damages from the issuer or other persons due to the violation of disclosure requirements.



other courts the fact of the violation is sufficient and they do not insist on proving the intent of the person to commit unlawful act<sup>36</sup>.

The Enron case of 2001 demonstrates that the main charge against Enron officers was falsification of financial statements which mislead the investors. Kenneth Lay and Jeffrey Skilling were sentenced to 45 and 24 years accordingly<sup>37</sup>. The result of this scandal was adoption in 2002 of the Sarbanes-Oxley Act.

The Sarbanes-Oxley Act of 2002 sets forth the obligation of the CEO and the chief financial officer to confirm that the company's periodic financial reports comply with the applicable requirements and reflect the main financial indicators of the company. The person who knowingly provides a false confirmation can be fined up to USD 1 million and/or imprisoned for up to ten years. Person who wilfully provides false approval can be fined up to \$5 million and/or imprisoned for up to twenty years.

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<sup>36</sup> Official site of legal firm Haynesboone [Electronic resource]: Criminal Enforcement of the U.S. Securities Laws by Ronald W. Breaux, Daniel H. Gold. Haynes and Boone, LLP. – См.: <http://www.haynesboone.com>

<sup>37</sup> The securities enforcement manual: tactics and strategies / contributing authors, Nicole A. Baker ... [et al.]; edited by Kirkpatrick & Lockhart LLP. – 2<sup>nd</sup>ed.