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Russian National Association of  
Securities Market Participants

# **RUSSIAN SECURITIES MARKET AND CREATION OF INTERNATIONAL FINANCIAL CENTER**

IDEAL MODEL OF THE RUSSIAN SECURITIES MARKET  
IN A LONG-TERM PERSPECTIVE (UNTIL 2020)

## **SUMMARY**

with the participation of

**Center for Capital Market Development**

 **ERNST & YOUNG**  
*Quality In Everything We Do*

  
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# Introduction

The actual Russian stock market which makes a typical example of a major developing one is in the mid-term outlook characterized on the one hand by high rates of positive quantitative and qualitative changes and for the other hand by numerous comprehensive issues impeding its dynamics evolution.

The objective globalization processes in the world capital market challenge the Russian stock market viability, so the national competitiveness turns into a critical factor for the national economic trend, national wealth rise and life quality improvement. The level of competitiveness becomes still more critical for the national financial markets since this sector is far more globalised compared to other ones. As a result of this a choice has to be made: to build a world/regional financial centre on the base of the developed national financial market or let the national financial market disappear altogether.

In next 15-20 years there will be no developing markets in the world and their operations with financial assets of developing countries' residents will migrate to developed markets. Hence the task to generate an ideal model of the national stock market and to turn the Russian stock market into a developed one is of vital importance for the national stock market survival. The Russian stock market will either become an efficient market or will pass into history.

The relevance of this question is for instance prompted by substantial share of foreign markets in total investments raised by Russian companies. Another pressing issue is the necessity to generate a productive infrastructure of the market to meet requirements of both domestic and foreign investors. The process to generate an efficient market-regulating system based on best practices is still pending. Last but not least obstacle is an unfavorable investment climate. All these reasons predetermine deficit of foreign long-term investors entering this country.

The actual paper strives to outline the ideal model of the Russian stock market long-term development (marking the year 2020 as a checkpoint). The "Ideal Model" term stipulates a set of quantitative and qualitative parameters of the market which enable it to be ultimately productive and ensure its competitiveness in the world.

This survey is methodologically based on purpose-oriented indicative planning principles. The sequence of the ideal model generation can be described as follows.

At the first stage we define core parameters of the model to most accurately depict the model as a whole. We calculate current values of quantitative indicators which characterize these parameters and track their history through the course of the Russian stock market existence.

At the second stage we identify target values of these parameters which make it possible to articulate basic parameters of the Ideal Model that is of the model of the stock market we should aim at in the long-term outlook. Target parameters are selected based on maximization on a multitude of possible values that is as a target we select the maximal value out of actually achievable ones.

The Ideal Model parameters target values are grounded through comparison of the Russian stock market with other developing stock markets by certain indicators. With the so-called "drag race" method being used we focus on the leading country by the parameter analyzed (among other developing financial markets) and examined the cause of this leadership. Thus we detect basic factors which pronounce critical competitive advantages of this or that national stock market against other developing markets and ensure highest value of this or that parameter. In terms of capitalization we select Hong Kong as the leader, in terms of cost of corporate bonds in circulation – South Korea and China, in terms of securities trade volume – South Korea.

At the third stage we define key factors to produce most influence on the whole range of parameters of the national stock market plus factors to boost investment demand in the stock market. To distinguish «most influential» factors we make wide use of other developing financial markets practice. To name factors of rise in the investment demand we also apply the economic analysis of Russian factors proper which build the investment demand from different types of investors.

Matching the stages of the survey we break the present report into three parts as well. The first part — "as is", the second — "to be" and the third — "what needs to be done".

It shall be stressed that the methodology adopted makes no projection as far as the market actual behavior is concerned and attempts simply to generate some plan of optimal development.

Target parameters indicativeness proper constitutes one of the major principles of the purpose-oriented indicative planning. This means that achievement of exact quantitative parameters is not mandatory: target values play the role of some benchmarks.

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Target parameters values rest on the proposition of preservation of the world financial market development conditions. One however may not exclude that this way of the world financial market development may come to an end. This although does not affect the Russian market since practically all conclusions we got from the proposition of preservation of the world financial market development conditions stand good for it. The point is that with any condition of the world financial market in the background there is a certain state of the national stock market which can be termed as “ideal” and the progress to this ideal state under any scenario of the world capital market development will stipulate rise in competitiveness of the national market against other national stock markets.

In other words the national stock market model “perfection” amid global competitiveness is always defined in comparison with other national stock markets which compete in the world capital market.

## Part 1 – “As is” Situation

As of 01.01.08 the RTS Group markets traded in 400 issues of shares (290 common and 110 preferred) including 103 issues in quotation lists (87 common and 16 preferred)<sup>1</sup>, at MICEX SE markets — 310 issues of shares (224 common and 86 preferred) including 93 issues in the quotation lists (77 common and 16 preferred)<sup>2</sup>. It should be noted that many shares get traded at both exchanges since Russia permits cross-listing.

The Russian stock market total capitalization in 2007 reached US\$1,341,5bln (RUR32,9trn). The Russian stock market turnover in 2005 was US\$179,8bln, in 2006 – US\$634,3bln, in 2007 – US\$1,230,0bln<sup>3</sup> which makes a close seven-fold rise in 2005 — 2007. The overwhelming majority of this turnover (99,993%) falls on MICEX and RTS Group exchanges.

MICEX accounts for 98,4% of the total shares turnover at Russian exchanges. In 2007 MICEX witnessed RUR30,9trn worth dealing in stocks including RUR15,6trn (50,5%) under repo transactions.

Subject to repo transactions accounting for a high share among all transactions one cannot evaluate the exchange turnover progress from the positive standpoint only. The outstanding quantitative rise is coupled with the turnover qualitative structure deteriorated. Repo transactions which make up 50% of the turnover are fraught with the risk of financial instability of investors and mediators.

The 2007 total volume of spot transactions and time transactions with shares and indices equaled RUR38,7trn including 59% of time transactions and repo transactions. The growth of time transactions’ share in the structure of the stock turnover is really natural for modern stock markets. High share of repo transactions however mismatches the world practice which initially applies futures and options to execute short term operations and to curb risks.

The Russian stock market features high concentration both in terms of capitalization and in terms of the turnover. In late 2007 10 most capitalized issuers accounted for 63%+ of the overall capitalization. Top 20 issuers made up for s+ of the national capitalization.

This indicator steadily declines, but it is still extremely high if compared to other foreign stock markets.

The market for most shares lacks liquidity since the essential part of the turnover organized falls on least numerous issues of most proactive traded shares. In total stock dealing across all Russian stock exchanges 10 top liquid shares as of 2007 accounted for 90,8% of the whole turnover (in terms of the year 2006 this concentration indicator hit 93,9%). 30 most liquid shares accounted for 98,9% of the total stock turnover. In other words nearly all Russian exchange turnovers fall within the utmost limited range of shares.

In late 2007 the overall volume of corporate bonds of Russian enterprises circulated at regulated markets made RUR1,231,4bln<sup>4</sup> (at face value). With this according to Cbonds agency the aggregate par value of corporate bonds in circulation in late 2007 was equal to RUR1,257,08bln (for comparison: in late 2006 – RUR901,8bln).

According to Cbonds agency the turnover of the Russian secondary exchange market of corporate bonds in 2006 was RUR1,799bln, in 2007 – RUR2,709bln. According to the same source the over-the-counter turnover of the bonds market in 2006 amounted at RUR 674,4bln, and in 2007 — RUR960,5bln.<sup>5</sup>

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1 Source: RTS ([www.rts.ru](http://www.rts.ru)).

2 Source: MICEX ([www.micex.ru](http://www.micex.ru)).

3 Including repo transactions.

4 According to CSMD.

5 Including transactions known to the National Depository Centre (NDC).

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Pursuant to the Russian FSFM the total volume of transactions with corporate bonds at the secondary exchange market equaled in 2007 RUR9,5trn (including RUR6,8trn under repo transactions). This makes a 37-fold rise against 2003. 99,98% of this volume is accounted for by MICEX.

The cost of open positions of futures and option contracts for securities and indices topped RUR111bln in late 2007. The number of open futures and option contracts for securities and indices as of late 2007 was 2,5mln.

The volume of time deals based on securities and indices in 2007 equaled RUR7,3trn including RUR6trn on futures deals and RUR1,3trn on option transactions.

The Russian time market has recently been increasing its capacity. For comparison: the total volume of open positions for futures and options for securities and indices was 2,24mln contracts (RUR78,5bln) in late 2006. The aggregate turnover of this market in 2006 was 89,6mln contracts for RUR2,708,5bln<sup>6</sup>.

The Russian stock market is characterized by high State involvement in the total structure of capitalization with this trend to be escalating over past two years. Five of top ten capitalized companies accounting for some 47% of the overall capitalization of the Russian stock market are directly or indirectly<sup>7</sup> controlled by the State: these are «GazProm», «RosNeft», SberBank RF, RJSC «UES of Russia», and VTB. According to Alpha Bank analysts the State's engagement in the overall capitalization of the Russian stock market as of early 2006 was 29,6%, and it rose to 35,1%<sup>8</sup> by early 2007. It poses substantial risks for the stock market stability.

The State active role in the capital of Russian corporations results in low number of free floating shares. Even issuers involved in exchange trading feature the free-float rate of 10% and less. This is especially true for companies seeking no public circulation of their shares. One should bear in mind that the formally declared free-float level (e.g. applied by exchanges to calculate their indices) is as a rule overrated against the actual level.

Talking about the industrial structure of Russian issuers one should notice persistent high concentration of capitalization and turnovers in stocks of fuel and energy enterprises with oil and gas producers being the leaders. According to the Centre for Capital Market Development this industry accounts for nearly fifty percent of the overall capitalization of Russian issuers as of 01.01.2008. It should however be remarked that the share of this industry in the structure of capitalization substantially reduced over 2007 through major IPOs gone through by this industry's companies. As of early 2007 oil and gas producers accounted for 65% of the national capitalization.

The other side of the low industrial diversification issue is that six major industries cover 90,1% of the national capitalization. Less dominant but still important to some extent role in the overall structure of capitalization belong to the financial services sector, energy, ferrous and non-ferrous metallurgy, communication. The least representation at the stock market is enjoyed by machine building, transport, chemical industry, trade, construction, services sector. The capitalization is unlikely to demonstrate dynamics and stable growth but for the stock market to undergo substantial industrial diversification.

Total funds raised by both companies and shareholders over last 11 years (from November 1996 to December 2007) through IPO at domestic and foreign markets including foreign companies with Russian assets can be evaluated at US\$58,0bln, including some US\$4,7bln in 2005, some US\$17,7bln in 2006 and US\$32,7bln in 2007<sup>9</sup>.

Full and accurate statistic data on the number of physical entities who trade at the stock exchange is not available in Russia. On compiling information from different scattered sources the following far incomplete picture emerges.

As of 01.01.08 physical entities accounted for 417,4K client accounts at the MISEX SE clients structure. The FORTS clients' structure (RTS Group) featured 11,9K client accounts belonging to private investors as of 01.04.07<sup>10</sup>. Pursuant to the National League of Managers (NLM) as of mid 2007 the unit investment fund "market" shareholders had some 450K accounts.

A separate new group of private investors is constituted by physical entities who participated in «popular IPO» of OJSC «RosNeft», OJSC «SberBank» and OJSC VTB. Some 115K people participated in IPO of «RosNeft», 30K — in IPO of «SberBank», 131K — in IPO of VTB. Mostly these buyers have a different (non-speculative) motivation and a different (long-term) time horizon for their investments compared to other groups of private investors stated above.

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6 Calculated based on RTS and MISEX data.

7 Including cross-shareholding.

8 See: B. Grozovsky «Main proprietor of the country». // «Vedomosti», 13.02.2007.

9 According to the Centre for the Capital Market Development.

10 As of 01.01.08. the whole list of FORTS clients included 26,3K.

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Since certain private investors cooperate with more than one broker or participate in several unit investment funds the figures obtained shall be discounted by 30-40%. Subject to this factor we evaluate the number of physical entities (residents) investing (directly or through pooled investments institutes) in the stock market to be equal 693 — 809K in early 2008. if compared to the economically active population of the country (75,3mln on 01.01.2008) this makes approximately 0,9 -1,1%.

According to FSFM Russia had 1030 unit investment funds as of 01.01.08 with total net assets value being equal RUR766,8bln. Pursuant to NLM as of 01.01.08 the total value of net assets of unit investment funds was RUR742,5bln, including RUR134,8bln with open-end funds, RUR43,7bln with interval funds and RUR564,0bln with closed-end unit funds<sup>11</sup>.

As of 01.01.08 there were 948 functioning unit investment funds with the net assets value being equal RUR717,2bln. In the breakdown RUR134,8 falls on open-end funds, RUR43,7bln — on interval funds and 538,7bln — on closed-end unit funds<sup>12</sup>.

Moreover the market feature 6 incorporated investment funds (IIF) including 3 «relics of check privatization» and other 3 set up after that law “On investment funds” was adopted. Their net asset value as of 31.12.2007 equaled RUR6,1bln. This form enjoys no popularity either with managing companies or with investors mainly through income double taxation.

According to FSFM as of 01.01.08 252 funds have valid licenses of a non-government pension fund (NGPF) including 126 funds are permitted for compulsory pension insurance (CPI). The own holding (total assets) of all NGPF as of 01.01.2008 made RUR593,9bln including pension reserves on the non-governmental pension benefits (NGPB) — RUR472,3bln and pension accruals on CPI – RUR26,7bln. The volume of assets to enforce charter activity (AECA) as of 01.10.2007 equaled RUR91,6bln. The number of participants to NGPB reached 6,7mln including 991K who receive non-government retirement benefit and 1,878K insured under the CPI program.

The aggregate investment resource of NGPF includes the whole volume of pension reserves and pension accruals plus a considerable AECA (some 50-75% according to our estimates) that is in general it equaled RUR540-560bln as of 01.01.2008. With this despite their liabilities are extremely «long» some NGPF invest not only in shares and bonds which are optimal for long-term investments but also in bills of exchange and bank deposits<sup>13</sup>.

According to CBR total funds invested by commercial banks in stocks of Russian joint-stock companies as of 01.12.07 reached RUR477,1bln without investments into stocks of subsidiary and dependant joint-stock companies. At the same time RUR140,9 fall on shares bought through repo agreements and through loan agreements being so devoid of the investment character.

Total investments of commercial banks into bonds and other debt securities of Russian legal entities as of 01.12.07 totaled in RUR1,188,3bln. RUR123,2bln however fall on loan notes acquired through repo and loan agreements being so devoid of the investment character.

According to CBR at the time market the scope of requirements of commercial banks on securities supply as of 01.12.07 equaled RUR154,7bln while their commitment rate on securities supply was equal to RUR114,8bln.

According to EmergingPortfolio.com information portal the value of investments from portfolio investment funds into Russia in early 2007 made approximately US\$23bln. Major investors in Russian shares are foreign investment funds investing in European developing countries and global funds for developing markets. Investments from global investment funds of shares currently act as a modest source of portfolio investments in Russia.

According to FSFM as of 01.01.2008 were issued 1445 licenses for broker activity, 1422 licenses for dealer activity and 1169 licenses on securities trust management. With this most licensees combined all tree or some two types of activity so that the overall number of licensed professional mediators was 1691.

The Russian broker market is highly competitive: by estimates 20 major internet brokers account for some 90% of the broker market when in the USA 5 major operators account for 95% of the similar market.

In this country we have no clear specialization of companies by the spheres of broker services – on the contrary the modern Russian stock market features universalisation of financial mediation. Commercial banks become more proactively engaged in stock market operations including brokerage. At the same time non-bank brokers

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11 Source: [http://www.nlu.ru/stat-count\\_pifs.htm?s=&b=&fd=01&fm=01&fy=2008](http://www.nlu.ru/stat-count_pifs.htm?s=&b=&fd=01&fm=01&fy=2008)

12 Data from the National League of Managers.

13 On 05.02.07 the Rf Government adopted Regulation No. 63 to affirm new Rules to invest NGPF reserves. The Regulation excluded bills of exchange as a possible asset, and NGPF will have to gradually get rid of them in 3 years. Since the Regulation comes into force NGPF cannot acquire new bills of exchange through pension reserves. As far as pension accruals on compulsory pension insurance are concerned they initially could not be invested in bills of exchange.

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proactively construct financial holdings including banks, insurance companies and other mediators. Most bank and non-bank brokers offer their clients investment-banking services. Distinction between internet-brokers and full-fledged brokers becomes vaguer: internet-brokers are proactive in rendering trust management services and investment consulting while nearly all off-line and full services brokers offer on-line trade services via Internet.

Exhausted traditional methods of competitiveness in the on-line brokerage market namely a reduced broker fee and deep discount marginal lending will inevitably result in higher concentration of the broker business. A strive for higher competitiveness and bigger client base mainly through regional clients already influences the transformation of the broker business: from numerous small broker companies to relatively big organizations with an extensive branch network in the regions.

According to FSFM as of 01.01.2008 Russia has 9 organizations licensed to arrange trades or a stock exchange and 12 organizations licensed as clearing companies. Nonetheless due to market competitiveness and objective integration processes de-facto have emerged two leading infrastructure centers – MISEX Group and RTS Group which actually generate the arranged Russian stock market.

**MISEX Group** is an integrated trade-settlement infrastructure which combines:

- Closed joint stock company «Moscow Interbank Currency Exchange»;
- Closed joint stock company «MISEX Stock Exchange»;
- Noncommercial partnership «National Depository Centre»;
- Nonbank credit organization «MISEX Settlement House» (CJSC);
- CJSC Joint stock commercial bank «National clearing centre»;
- Seven regional exchanges (Saint-Petersburg, Nizhny Novgorod, Samara, Rostov-on-Don, Yekaterinburg, Novosibirsk and Vladivostok),
- National commodities exchange

MISEX Group combines the following markets:

- Stock market;
- Market for government bonds and Money market;
- Currency market;
- Time market;
- Commodities market.

**RTS Group** is an integral trade-settlement infrastructure which combines:

- Noncommercial partnership «Russian Trade System Stock Exchange»;
- Noncommercial partnership «Saint-Petersburg Stock Exchange»;
- Open joint stock company «Russian Trade System Stock Exchange»;
- Closed joint stock company «RTS Clearing Centre»;
- Nonbank credit organization «RTS Settlement House» (LLC);
- Closed joint stock company «Depository-Clearing Company».

RTS Group includes several arranged markets:

- Classical market;
- Exchange market;
- FORTS.

The Russian stock market includes two alternatives in accounting rights to securities: by depo accounts with the depository and by subledger accounts in the register. Depositories, registrars and issuers who maintain registers of their shareholders make up the stock market accounting system in total.

By FSFM data as of 31.12.2007 there were 787 organizations with depository licenses (as of 31.12.2006 the number was 831 and as of 31.12.2005 — 743). The number of organizations licensed to maintain registers of securities owners was 66 (as of 31.12.2006 – 73 and as of 31.12.2005 — 82).

Russia has witnessed separation of depositories into settlement and custodial ones which is a common world practice.

Leading settlement depositories are the National Depository Centre (NDC), Depository-Clearing Company (DCC) and Settlement-Depository Company (SDC). Major custodial depositories — «ING Bank (Eurasia)», «GasPromBank», VneshTorgBank, RosBank, Deutsche Bank, VneshEconomBank.

According to PARTAD the overall volume of securities deposited with 30 Russian major depositors as of 30.06.2007 constituted by the market value RUR21,5trn including shares – RUR17,3trn, bonds (including

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government) — RUR4,1trn, units of investment funds – RUR33bln. It should however be born in mind that «double counting» is possible here since one security can be reflected on some account of the settlement depository and its client — custodial depository.

By the year 2006 Russia had mostly developed a legal base to regulate the stock market. The base is made of a number of laws («On the stock market», «On protection of rights and legitimate interests of investors in the stock market», «On mortgage securities») which define general rules in the stock market and through numerous subordinate legal acts (mostly through Regulations of the Russian Government and Orders of the Federal Service for Financial markets) set special norms. In particular subordinate legal acts sets the order of securities emission and requirements to professional participants of the stock market – dealers, brokers, securities managers, depositories, clearing houses and market makers.

Separate institutes of the stock market are regulated by special laws: «On investment funds», «On non-government pension funds», «On funds investments to finance the funded component of the retirement benefit», «On the savings-mortgage system of housing provisioning for servicemen» accompanied also by substantial subordinate legislation.

The Russian system of the stock market regulation emerged in parallel with the market itself and in many aspects profoundly contributed to its development. The overall system includes the world practice in stock markets regulation and matches the world development trends in this field. Although it has some national peculiarities, and the key one is an intricately structured distribution of regulatory and supervisory authorities among several agencies. By this time most relevant functions in the field of the stock market proper have gone to one state agency — the Federal service for financial markets. Certain authorities however remain with the CBR and (to less extent) with the Finance Ministry.

## Part 2 – “To be” Model

The review performed enables to suggest values of core parameters of the Russian stock market model subject to which the model can be characterized as the ideal one.

The Russian stock market ideal model envisages the following basic parameters to be achieved by 2020<sup>14</sup>:

### I. By the stock market

#### 1. Capitalization

In terms of capitalization the Russian stock market will enter the leading edge to make part of the “G4” together with the US, the UK and the Japanese markets. Subject to certain conditions the “G4” may translate into “G5” through China involvement. By 2020 Russia will probably have entered the capitalization top 3 in the world. The Russian market will become the major developing one which by capitalization will outperform Hong Kong, China, Korea, South Africa, Brazil, India and other countries with developing financial markets. In numbers the stock market ideal model envisages the capitalization range varying between US\$5,4–5,6trn. Getting the upper hand within the BRIC group (Brazil, Russia, India, China) Russia will rechannel to its benefit the world flows of direct and portfolio investments.

It is worth mentioning that the ideal model is characterized not by the maximal level of the national capitalization but its steady (with no substantial interim falls) rise in the long-term outlook to ensure stable outperforming development of the stock market against the rest of economy.

This requirement is grounded not simply by the necessity to provide for the capitalization maximal level but to ensure the national capitalization volume optimization subject to existing limitations. The first limitation is the necessity to ensure a progressive stable rise for the national capitalization. Another limitation making the reverse side of the first one is connected with the necessity to avoid “bubbles” resulting from ungrounded overrating of Russian shares value and consequential sharp fall in national

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<sup>14</sup> Numerical values of the ideal model parameters follow the assumption of preservation of trends that evolved over the last 10 – 15 years in the world financial market.

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capitalization (through decline in indices and through some companies leaving the market including in view of bankruptcy).

Stable rise in the national capitalization as a necessary condition envisages improvement of qualitative parameters of the capitalization structural characteristics including the diversification of the economy industrial structure and the diversification of the capitalization industrial structure as well as the capitalization deconcentration (fall in major corporations' share in the national capitalization). As prompted by the Russian recent practice all these changes can be most pro-actively achieved through the IPO process stimulation.

A key factor for the capitalization outrunning growth lies in energetic promotion to the market of investment-attractive companies with high potential of the capitalization long-term growth. Such an exit for the company previously devoid of an arranged market for its stocks may be in becoming actually public. This result goes from the altered structure of the corporate development objectives and appearance of such objectives as obtaining the market assessment of the business value and raising new investors and additional finance resources to solve corporate development issues. More important however is a new company entering the market through IPO.

Preparation of the Russian stock market ideal model envisages profound decline in the capitalization concentration. As was already stated above definite quantitative benchmarks for these parameters alteration call for an additional survey. In any case however the share of the top 10 major companies in the national capitalization shall go below the average value for developing markets and approach the average value for developed markets. At the qualitative level the share of the top 10 major companies in the national capitalization by 2020 shall have decreased to 40–45%. The industrial capitalization parameters also necessitate substantial reduction.

Another qualitative parameter of the stock market impacting the quality of the national capitalization — percentage of free-floating shares. Under the ideal model this indicator may be 50–60%.

## 2. Price/Earnings ratio of Russian companies

Here the parameter of the ideal model to reflect the market accuracy in Russian stocks evaluation is the P/E ratio. The level of this indicator shall manifest Russian corporations' accurate assessment by the market (that is witnessing neither underrating nor overrating of the Russian stocks). In this case the Russian stock market can be termed ideal from the viewpoint of the Efficient Market Hypothesis by Eugene Fama.

Switching from theory to practice however one should specify this notion as follows. To match the ideal stock market term we need a high level of stability for the Russian market P/E ratio against world-average values with slight stable overbalance of for the Russian market P/E ratio against average values on a relative group of countries since it prompts higher long-term investment attractiveness of the national market against competing ones.

## 3. Capitalization/GDP ratio

The ideal Russian stock market model stipulates closer connection between the GDP and the capitalization growth rates when the capitalization dynamics in the long-term immaterially but steadily outperforms the overall economic dynamics including the GDP dynamics. On the one hand this means less separation of the capitalization dynamics from the GDP dynamics and on the other hand — substantial rise in stability of the capitalization dynamics. Let's repeat once again that the ideal Russian stock market model will feature insignificant but persistent outperformance in terms of capitalization growth against the growth of the overall economy.

Shall the present trends continue the capitalization/GDP ratio will have been equal to 190% by 2020. From our standpoint this level will be pretty sufficient to generate the ideal stock market model in Russia. This means that the State shall focus not so much to maximize this ratio but to qualitatively improve the capitalization dynamics and its structure. The quality of the capitalization growth envisages rise in its stability. The capitalization improved structure pronounces fall in the capitalization concentration as well as rise in number of the free-floating shares. Both aspects of the capitalization improvement envisage productive government policy to stimulate the stock market development and to ensure a favorable investment climate.

To ensure stable rise in capitalization we need to exclude the recurrence possibility of a crisis similar to the 1997–1998 one. Namely this factor- the crisis factor may in the long-term outlook most profoundly affect the national capitalization dynamics. So a key to guarantee a steady growth of capitalization in Russia is to ensure

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the domestic stock market immunity sufficient to resist external crisis factors originating from the world capital market or from other sectors of the Russian financial market.

Another major factor of the stable growth of the national capitalization is dynamic and productive development of the overall national economy. In relation to the stock market this factor is an external factor, an «external environment» factor, but nonetheless its presence is mandatory to achieve target benchmarks by capitalization and the capitalization/GDP ratio. Provided that such development in present economic conditions is possible only through sharp rise in investment volume and accordingly prompt renewal of the fixed assets a favorable investment climate in the country becomes really essential.

To preserve a stable rise of capitalization amid crisis in the world capital market some other conditions shall be observed to maintain the national stock market stability against negative external shocks. In relation to Russia these negative shocks can be divided in two groups: the world capital market shocks and world feedstock markets shocks. Stable rise of capitalization in Russia necessitates resistance insurance against both the world capital market shocks and world feedstock markets shocks.

Resistance to the world capital market shocks initially stipulates high demand for stocks from internal investors in Russia. The major source of demand from domestic investors in most countries is people's savings.

#### 4. Raised capital / fixed capital investment ratio

When establishing the Russian stock market ideal model the ratio between the raised capital and the fixed capital investment shall approximately match the level of the second leading group among developing markets and among major stock markets with most pro-active IPO segments.

As can be traced from above the IPO factor is a major one both in terms of the stock market capacity and in terms of its liquidity. The IPO market progressive development in itself makes an important condition of the Russian stock market ideal model generation.

The numerical value for the raised capital / fixed capital investment ratio as a parameter of the stock market ideal model equals — 11%.

In absolute figures by 2020 annual funds raised by issuers through IPO in the domestic market will equal:

- at permanent prices (the 2007 prices) – US\$27,6bln or
- at the 2020 current prices (US\$ assessment) – US\$77-96bln or
- at the 2020 current prices (RUR assessment) – RUR2trn

To achieve this level we need to alter two core factors which define the IP volume in the domestic market:

- Increase demand for the stock market instruments including demand in the primary market;
- Decrease transactional costs of issuers when promoting to IPO in the domestic market.

#### 5. Domestic stock market liquidity

The stock market ideal model generation is conditioned by Russia's absolute leadership in the exchange stock trading / capitalization ratio among developing markets. This calls for a substantial rise in stock dealing in domestic stock exchanges. The ideal model will be featured by US\$10,3-10,6trn in annual stock dealing in domestic exchange markets by 2020.

To get to this level we need to improve the following core factors which define the level liquidity in the domestic stock exchange market:

1. Development external conditions which include:
  - Investment climate;
  - Economy monetization level;
  - Inflation rate;
  - Population income rate;
  - Pension system condition and capabilities.
2. Openness level of the national stock market.
3. Role and behavior of the population in the stock market.

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4. Share of stocks in portfolios of pension institutes and pooled investment organizations and insurance companies.

5. Level of transactional costs.

6. Capital raising intensity in the stock market (IPO).

It is worth mentioning that the liquidity proper is the crucial factor of competitiveness of the Russian stock market amid modern global competitiveness.

A sign of a developed financial market is currently a stable growth of the exchange stock dealing volume / capitalization ratio. To ensure the upward trend a developing stock market shall provide such conditions for stock (companies-residents) dealing which would be competitive against similar conditions with developed markets. Amid the global environment the investor may obtain access to the stock of a certain company not only in the market where it is registered but also in major world stock dealing centers. Hence these competitive conditions move the country to a developed stock market. Moreover final stabilization of the trend when the turnover / capitalization ratio grows is possible only when the national stock market turns into a developed one, into an international financial centre. So the ideal Russian stock market model pronounces translation of the Russian stock market into a developed one at least from the point of view of transactions terms.

An important factor for the stock market liquidity growth is an increase in the number of free floating shares. As was already mentioned amid the ideal model conditions this share shall reach 50 – 60%.

To hit the target level of the Russian stock market liquidity is it necessary to implement a set of measures to radically increase liquidity of domestic exchange stock market. One shall bear in mind a number of factors capable of speeding up the stock dealing in Russian stock exchanges:

- Investment climate factors;
- Macroeconomic factors;
- Receptive Russian stock market at foreign exchanges (initially at LSE) which can partially migrate to the domestic market (when required competitive advantages are set up in the domestic market).

The last resource is capable of fastest feedback while first two factors are more time-consuming. The objective to transfer operations with the Russian stock from foreign markets into the domestic one which envisages competitive (in comparison with transactions terms in developed markets) transactions terms for the Russian stock in the domestic market can be achieved through high efficiency of Russian stock exchanges and the accounting-settlement infrastructure.

It should be noticed that higher efficiency of the accounting-settlement infrastructure will also cure another problem hampering the liquid stock market development in Russia – the stock market atomism. Actually Russian stock circulates in the domestic market in two exchanges and stock transfer from one floor to the other is rather consuming (first of all time-consuming). To put these expenditures down we need to establish a central depository and generate the centralized clearing mechanism since namely these conditions will contribute to the stock market integrity and to the rise of its liquidity.

In theory to principally overcome the domestic stock market atomism we can either establish a centralized accounting-settlement system to minimize costs of stock and funds transfer among different trade floors and brokers or through consolidation of the trade systems. From our point of view the second variant looks more efficient.

## II. By the corporate bonds market

### 6. Value of the corporate bonds in circulation

To prepare the Russian stock market ideal model the Russian corporate bonds market shall be comparable by its receptiveness with major developing markets in Korea and China. Thus the value of corporate bonds in circulation by 2020 shall have reached US\$850–1,100bln.

Among key factors to define the receptiveness of the circulating corporate bonds market and accordingly its role in the economy we feature:

- Strength of the national currency;
- Number of state guarantees by corporate bonds;
- Investment climate;

- Efficiency of the investor's interests protection including defaults prevention;
- Broadness of the structure of corporate bonds issuers and of the structure of corporate bonds types;
- IPO processes intensity which impacts on the volume of the equity capital of the enterprise and accordingly on the debt level.

Moreover the dynamics of the corporate bonds market's receptiveness is characterized by the organizational type of this market (exchange or OTC). In most cases more or less liquid corporate bonds market ensures higher growth of the corporate bonds market receptiveness. With this the pace rate of such a market perceptiveness does not go down through qualitative change of the market's volume that is stay high over a long period.

The influence transfer mechanism can be worded into the following tentative assumption. Exchange organization of the corporate bonds market ensures higher liquidity of this market which invites new companies as investment recipients. In addition those companies which once have let bonds into the exchange market obtain a most productive engine to refinance loans and to manage their debt (which in combination provides for self-expansion of the bonded loan market of each separate issuer).

As a practical conclusion out of the exchange-like character of the corporate bonds market organization we may point out the necessity to:

- Preserve the exchange corporate bonds market;
- Prompt maintenance and development of this market liquidity.

All this means no prohibition to develop OTC trade of corporate bonds which can only boost the positive impact due to the liquid exchange market.

### III. By the foreign securities market

#### 7. Share of foreign securities in Russian stock exchanges' listings and turnovers

A sign of high competitiveness reached by the Russian stock market when the stock market model can be termed as ideal is hitting the mid – typical of developed markets – level of foreign securities' share in the overall stock traded in Russian stock exchanges. With this Russia shall lead by this parameter amid developing financial markets. Thus the ideal model of the stock market stipulates the share of foreign securities in listings and turnovers of Russian stock exchanges to be equal at least.

### IV. By the securities time market

#### 8. Number of transactions in the time market

The Russian stock market can be termed ideal subject to the securities time market in terms of receptiveness becoming the leader among developing financial markets. It is supposed that to generate the ideal stock market model the securities time market transactional volume shall equal US\$20-21trn by 2020.

### V. By characteristics of the stock market investors' core groups

#### 9. Number of people in Russia who invest in stock through brokers.

The role of the population in the stock market as well as that one of the IPO is an important factor of the stock market model generation by other fields here by capitalization, liquidity, the corporate bonds market receptiveness. Simultaneously the role of the population in the stock market is in itself one of parameters of the stock market model proper. Factors to define the role of the population in the stock market are:

- Rate of the actual income of the population and its dynamics;
- Rate of the financial literacy of the population and rate of their knowledge of their rights as investors;
- Productivity of the system of informing the investors;
- Productivity of the system of access to trades and systems of distribution of financial products in pooled investment organizations (both in terms of territorial accessibility and time and money expenditures);

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- Tax regime efficiency;
  - Variety of ways for the population to access the market.

To match the ideal model this parameter in Russia shall be among top with developing markets and surpass the developed financial markets for both banks dominant markets and debt financing dominant markets. That is the share of the Russian population investing in stocks through brokers shall match 20%. Two additional conditions shall be taken into consideration. First this share shall rise primarily through investors with long-term investment horizons with the relevant capital and the adequate level of financial knowledge that is «responsible» investors. Second increase in population investing through brokers shall be accompanied by rise in the share of population involved in pooled investment organizations.

## 10. Net asset value for open-end and interval investment funds

The target parameter of the stock market ideal model in relation to investment funds development equals 15% of investment funds share in GDP. In monetary terms this comes to US\$470–560bln (target assessment of investment funds' net asset value).

This rate of development can be achieved for investment funds shall the present rate of open-end and interval investment funds' net asset value growth persist. The difficulty lies with the fact that the pooled investment industry had moderate dimensions at the time when it demonstrated such growth rates. For a bigger market it is very difficult to preserve such growth rates.

To preserve the unit investment funds' current growth rate amid their appreciation for the next decade we need to adopt certain measures to profoundly improve their efficiency. Among major obstacles to further qualitative growth of the unit of investment funds' industry there are savings distribution among numerous small funds, lack of productive sale channels, underdevelopment of the exchange shares market and of the systems for centralized clearing and settlement on transactions with these financial instruments. By the size of open-end and interval unit investment funds Russia on average is 10 times below European funds and approximately 60–70 times below American mutual funds. The core reason lies in lack of actual competition between different unit investment funds and of efficient technologies which let investors to redistribute investments in funds depending on their efficiency. Since Russia features no legislation and standards to regulate investment consultants' activity and their fiduciary responsibility to investors this results in unregulated conflicts of interest when selling shares through agents and other financial mediators which in turn makes these financial instruments less inviting for retail investors.

## 11. NGPF' reserves

The target benchmark of Russian non-governmental pension funds' development shall equal mid parameters of “Pension reserves/GDP” and “Pension reserves/capitalization” coefficients. For the purpose of such a benchmark we can distinguish Japan where the stock market has a proper balance of pension reserves. Investment and pension funds account for 14,2% of Japanese GDP; 18% of capitalization. Hitting 15–20% in Russian NGPF / capitalization ratio in 2020 will pronounce a rise lift from actual US\$19bln to US\$840–1080bln (according to the optimistic scenario of the capitalization growth). NGPFs will turn into a powerful internal factor to sustain growth of capitalization and of the whole Russian stock market.

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Shall the long-term pace of the world capital market' growth speed up this will call for raising the ideal model's numerical parameters and accordingly the decline will pronounce lower values. Although under any conditions of the world capital market development shall stand the above mentioned qualitative descriptions of parameters of the ideal model.

The set of the above mentioned parameters of the ideal model may have only qualitative characteristics. At the same time some parameters have definitely set quantitative values. Namely this group of the ideal model's parameters can be immediately engaged in the indicative planning process by way of identification of target benchmarks of the stock market long-term development.

Numerical values of the ideal model's quantitative parameters (based on the assumption that past decade's trends of the world financial market will persist) and their excess over the current parameters are cited in the table:

Target benchmarks' numerical values / current numerical values ratio

Parameter	Current value (as of 2007)	Target benchmark	Excess (times)
Capitalization	US\$1,342,0bln	US\$5,4-55,6trn	4,0-4,2
Stock dealing volume in domestic exchange markets	US\$1,230,0bln	US\$10,3-10,6trn	8,4-8,6
Raised (through IPO in the domestic market) capital / fixed capital investment ratio	7,0%	11%	1,6
IPO volume in the domestic market *	US\$17,7 bln	US\$77-96bln	4,4- 5,4
IPO volume in the domestic market in the 2007 prices	US\$17,7bln	US\$27,6bln	1,6
Raised (through IPO in the domestic market) capital / fixed capital investment annual average ratio **	3,1%	11%	3,5
IPO annual average volume in the domestic market ***	US\$5,5bln	US\$75-93bln	14-17
Value of corporate bonds in circulation	US\$50,2bln	US\$850-1,100,0bln	17- 22
Foreign securities' share in Russian stock exchanges listing and turnover	0	12%	+ ∞
Size of the securities time market (number of time transactions)	US\$284,bln	US\$20-21trn	70-74
Share of people in Russia who invest in stock through brokers ****	0,4%	18%	45
Number of Russians investing in stock through brokers	560K	25mln	45
Open-end and interval investment funds' net asset / GDP ratio	0,5%	15%	30
Open-end and interval investment funds' net asset value	US\$7,3bln	US\$470-560bln	65-77
NGPFs' reserves / capitalization ratio	1,43%	15-20%	10-14
NGPFs' reserves	US\$19,2 bln	US\$840-1,080,0bln	44-56

#### Notes.

- \* When assessing the target value of the IPO volume the accent is put only on the volume of financial resources which will be at disposal of the issuers. The "Target benchmark" column the assessment is made in the 2020 prices (US\$-denomination).
- \*\* The "Current (2007) value" column includes the annual average value of this ratio for 2005-2007; the "Target benchmark" column contains the annual average value of this ratio for 2018-2020.
- \*\*\* The "Current (2007) value" column includes the annual average value of this parameter for 2005-2007; ; the "Target benchmark" column contains the annual average value of this parameter for 2018-2020.
- \*\*\*\* The share is calculated based on the assumption that the population of Russia will be 140mln in 2020. It is worth mentioning that here we apply the total number of people in Russia and not just the number of the gainfully occupied people.

As was already mentioned it is impossible to accurately define exact numbers of the time market receptiveness parameter as well as the P/E ratio to serve as a benchmark for a decade.

The table highlights points where the prime focus is required to promote attributes of the Russian stock market ideal model. In our vision these core fields are:

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1. Most critical fields
    - i. Stimulate a multiple rise in the number of people who invest in securities in the stock market;
    - ii. Set up a sector foreign securities and increase their share in the domestic market;
    - iii. Provide a dramatic rise in the investment funds' net asset value;
    - iv. Ensure a sensible increase in pension reserves;
  2. Other important issues:
    - i. Skyrocketing stock dealing in the domestic market;
    - ii. Profound uplift of value of corporate bonds in circulation;
    - iii. Momentum to the domestic IPO market establishment and evolution;
    - iv. Steep investment uphill from foreign portfolio investors;
  3. Still other points of the ideal model generation — ensure a stable long-term rise in the capitalization when the growth pace insignificantly but steadily exceeds in the long-term outlook the economy growth rate.

Moreover based on the current position of the Russian securities time market in the world hierarchy of national time markets it is clear that one more important thing is outrunning development of the securities time market.

Domestic IPO market establishment and evolution: despite the fact that following the 2007 results the gap to the target level was profoundly reduced the issue of this parameter stability is still pending. Bearing in mind that the IPO annual volume makes an extremely volatile parameter it is more accurate to ground on the value of this indicator average over a number of years. The above table implements this approach proper.

By the formal feature of the lagging level the IPO market development issue entered the “Still other points” segment of our classification. Review of internal interconnections of factors and parameters of the stock market model however revealed closer connection among the IPO volume parameter and many other key parameters of the model. So intense promotion along this direction is still critically important for the stock market ideal model in general.

## Part 3 – International Financial Centre: Background of Russia's Competitiveness and Ways to Improve It

The modern stage of the world financial system development presupposes full-fledged financial markets preservation within a limited range of most developed countries only. In the coming decade a national financial market functioning as a global or international financial centre will be a mandatory condition of full economic sovereignty and simultaneously a sign of a great nation.

An international financial centre is characterized by three major points:

1. Concentration of capital (investment demand concentration) with a sensible share of the foreign capital;
2. Concentration of financial mediation (concentration of financial services) with a serious share of services rendered by mediators who act in the global market, efficient infrastructure;
3. Concentration of tools (concentration of the investment proposal) with a major share of instruments proposed by foreign institutes.

An important feature in our view is high concentration of the investment demand that is accumulation of big capital investable and invested within the financial centre. The concentration of capital means capital outflow from other countries within the area of the financial center influence which results in the additional capability of the financial centre to redistribute to its benefit the world wealth.

Close interconnection of three core features of the financial centre means that the financial centre can be generated only subject to the capital concentration, financial services concentration and the infrastructure efficiency provision as well as concentration of tools and consequently subject to execution of all three conditions of this concentration.

Currently approaches are being developed to define features of financial centers and their classification — these features are already included in ratings. These ratings compare advantages of certain financial centers and in

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the outlook these ratings can become an efficiency criterion for numerous financial centers generation programs which appeared in different countries over last years.

The most authoritative rating of this kind is GFCI in the Square Mile. First published in 03.07<sup>15</sup> with the second report published in 09.07 (GFCI2)<sup>16</sup>. This index is calculated by the so-called “assessment factors model” which combines ratings and rankings of countries by different formalized parameters supplemented with financial specialists’ opinions based on their answers to questions arranged by the survey initiators.

The first GFCI put Moscow on the 45 position out of 46 behind most developing financial markets which are Moscow’s immediate competitors in the global capital market: Shanghai (24), Dubai (25), Beijing (34), Mumbai (39), Warsaw (40), Prague (41), Seoul (43), and Budapest (44). The second GFCI didn’t include Moscow in its top 50 which at that time additionally incorporated in particular Johannesburg, Bahrain, Qatar, Sao Paolo.

Russia competes with already formed global financial centers, international financial centers, niche financial centers (in relevant niches) and national financial centers which are not yet international but which as well as Russia strive to turn into a regional financial center in the same world region.

For the purpose of an example of financial centers seeking an international position in the same region with Russia we can name Poland and Kazakhstan. These countries have actually developed a strategy of turning into an international financial center and their government policy in the field of the financial market is this objective-oriented. However Poland and Kazakhstan differ in the initiator of the financial center development – in Poland this process is recently being stimulated by the Warsaw Stock Exchange while in Kazakhstan the key concern is manifested by the State.

Major competitive advantages of Kazakhstan to become a regional financial center seem to include:

Top favor regime from the part of the State;

Maximal tax benefits for investors operating within the center, for all operations within the center and in relation to issuers;

Specialized financial court;

Easier access for foreign financial mediators and high quality securities;

Settlement by securities in many currencies;

Productive consolidated infrastructure;

State (financial) involvement in infrastructure generation for the financial center;

Special legal regime established within the center to match existing international standards and European regulations.

Key competitive advantages of Poland are:

Legal regime in full compliance with European regulations;

Inclusion in the quotation list of the Warsaw exchange lets inclusion in relevant lists of other European exchanges<sup>17</sup>;

Sound potential of the investment demand on behalf of residents<sup>18</sup> and non-residents<sup>19</sup>;

Mature receptive IPO market manifesting considerable investment demand for new stock properly;

Possibility for relatively small companies<sup>20</sup> to profitably<sup>21</sup> place stock;

Listing simplified requirements.

Poland and Kazakhstan are not the only Russia competitors in the world financial market. Financial centers in the South-East Asia (Hong Kong, Korea, Singapore) can consider operations with Russian financial assets as a possible additional resource subject to redistribution within the global financial world. Developing and developed financial centers may seek not only to redistribute to their benefit some operations with Russian financial assets but to fully acquire the Russian financial market.

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15 The Global Financial Centers Index. March 2007. – L., City of London. 2007.

16 The Global Financial Centers Index. September 2007. – L., City of London. 2007.

17 In accordance with the EU unified regulation terms of placement with the Warsaw Stock Exchange are common for all EU markets (pursuant to regulation 809/200) consequently next placements of the same company with the same prospect can be executed with any European Stock Exchange. Listing at WSE enables a company to latterly trade in any other European Stock Exchange.

18 By assessment of the Warsaw Stock Exchange the potential total demand for securities from domestic investors reach Euro175bln.

19 By data from the Warsaw Stock Exchange the share of non-residents in the total investment demand at exchange trading sessions approximately equals 40%.

20 According to the Warsaw Stock Exchange in 2004–2005 44% of all IPO at the Exchange were below Euro10mln, 45% — Euro10-100mln and only11% — Euro100+mln.

21 Pursuant to the Warsaw Stock Exchange IPO costs in Warsaw make only 5–7%. Placement arithmetical mean value according to the Warsaw Stock Exchange is 6%, while in London this figure is 18% (again by the Warsaw Stock Exchange).

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What are the outlooks for Russia in terms of the share of the world capital market Russia may obtain as an international financial center.

From our standpoint this financial center area of influence may include CIS and optimistically certain countries in Western Europe and in Mid East. Possible area of influence of the Russian financial center may include:

A. Conservative variant:

Ukraine, Belarus, Kazakhstan, Moldova, Uzbekistan, Kyrgyzstan, Tajikistan, Armenia, Azerbaijan, Mongolia

B. Optimistic variant:

Ukraine, Belarus, Kazakhstan, Moldova, Uzbekistan, Kyrgyzstan, Tajikistan, Armenia, Azerbaijan, Mongolia, Turkmenistan, Georgia, Latvia, Lithuania, Estonia, Finland, Poland, Slovakia, Romania, Bulgaria, Serbia, Montenegro, Albania, Bosnia and Herzegovina, Croatia, Macedonia, Greece, Cyprus, Turkey, Iran, Syria, Israel, Iraq, Lebanon.

The second part of this survey presented core parameters of the national stock market model and their target values which also enabled to identify critical directions on the move to the ideal model. Lets examine them from the point of compliance with relative features of an international financial center – concentration of capital, concentration of financial mediation (financial services), productive infrastructure and concentration of instruments.

1. High concentration of capital.

The capital concentration issue is probably the most critical one. Capital concentration presupposes concentration of both national and foreign capital for stock dealing. Both components are important since only good balance in the capital market ensures high stability of the capital, its stable development and maximal opportunities to finance the national economy. To achieve high concentration of capital it is required to:

Provoke a multiple increase in the number of people investing in stock;

Ensure solid rise in the net asset value of investment funds;

Provide for a good increase of pension reserves;

Prompt dramatic investment rise of foreign portfolio investors.

2. Concentration of financial mediation (concentration of financial services), efficient infrastructure.

The task to concentrate financial mediation includes creation of a broad mediation base both national and (as daughter companies) foreign. Mediators for us here are broker and dealer companies, investment banks and portfolio managers.

An efficient infrastructure is a natural sign of an international financial center – stock exchanges and other initiators of the trade, institutes to account rights to securities and other financial instruments and to settle these transactions. The infrastructure productivity can be assessed by the competitiveness of conditions which it proposes and trends which push its development in the actual world financial market.

A most critical thing in view of this task is a profound lift in stock dealing in the domestic market.

3. Concentration of instruments

The Russian stock market already hosts core types of financial instruments – share, debt, derivative instruments. A serious disadvantage is a lack of instruments to securitize assets (save mortgage securities), low national debt market against the foreign debt market of Russian companies, lack of numerous segments in the derivatives market and shaping separation of financial and commodity instruments.

Measures to broaden the range of instruments shall be as pro-active as measures to concentrate the investment demand – otherwise a supply and demand misbalance appears, the investment demand heads for a limited range of instruments with insufficient free-float which groundlessly puts the price up and create additional risks for investors.

The concentration of instruments issue calls for:

IPO domestic market set-up and pro-active development stimulation;

Skyrocketing value of circulating corporate bonds;

Securitization possibilities provision and structured products set-up;

Time market development;

Foreign securities sector creation and their share increase in the domestic market.

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The present paper omits a substantial comprehensive list of exact measures proposed to turn the Russian financial market into an international financial center. These measures made part of two most important strategic

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documents prepared by Russian State Authorities which define basic fields of regulated influence on the financial market in the long-term outlook: the Russian financial market development strategy till 2020 and the Concept of the international financial center evolution in Russia.



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