Leveraging the Presence of Russia in the U.S. Capital Markets

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Despite being characterized as a sweeping and impactful new round of economic and financial penalties targeting Russia in response to the SolarWinds hacks and other offenses, the measures announced by the Biden Administration on April 15 stopped short of fulsomely targeting Russia's presence in the U.S. capital markets in a manner that could have had far more significance – and potentially market moving – consequences. Indeed, some in the business community who had braced themselves for something tougher quickly pointed out that this restraint not only softened the impact on the Kremlin, but also on those either helping to fund their activities or that are invested in their success.[1] Specifically, the latest round of sanctions avoided targeting Russia in the capital markets in the following three ways:

1. U.S. persons are still permitted to trade and hold Russian sovereign debt via secondary market transactions, meaning Russian sovereign bonds acquired indirectly are not targeted for forced divestment or otherwise implicated by the latest penalties;

2. U.S. persons that purchased Russian sovereign debt directly from the Russian government when it was issued (i.e., primary issuances) are permitted to hold such debt to maturity and do not appear required to divest such holdings; and

3. there was no mention of additional capital markets sanctions targeting Russian corporate "bad actors," including those already under official U.S. sanctions, that are also currently present in the investment portfolios of scores of millions of U.S. retail investors (i.e., via index funds, past participation in stock or bond issuances or via trades made in the secondary market for these securities).

Public comments made by U.S. officials indicate that there is awareness of these additional sources of unused leverage, indicating that restraint in these areas appears to have been intentional, as part of an effort either to show a measured response or to leave room for strengthening sanctions in the future. Depending on the fate of the jailed dissident Alexei Navalny, a prominent political

[1] https://www.ft.com/content/bb555605-1c1e-4144-bc99-d05b58dc61d7

opponent of President Putin, the full use of these tools would be on the table for action by the Executive Branch or the Congress.

The *Washington Post* reported that such measures may be on the minds of U.S. officials, attributing to unnamed U.S. officials the notion that "the administration is reserving the right to broaden the scope of the sovereign debt sanctions to include secondary markets if Moscow's malign activities persist." In the meantime, as summarized below, U.S. and other investors retain significant, untargeted financial exposure to prominently sanctioned Russian actors, even underwriting the Kremlin itself.

It is worth noting that Biden Administration officials should already be familiar with the leverage offered by the full use of the U.S. capital markets to impose economic and financial penalties on "bad actors," due to the existing use of this pressure against Chinese companies under Executive Order 13959 that was issued in November 2020. As described below, these measures prohibit U.S. investors worldwide from holding the securities (i.e., stocks and bonds) of Chinese companies – including those in index funds and other passive investment vehicles – which appear on the Section 1237 Pentagon List of "Communist Chinese Military Companies" (CCMCs) or their majority-owned subsidiaries. Indeed, the Executive Order mandated divestment of these entities within one year's time.

Russia Retains Its Access to the U.S. and Global Capital Markets

In general, while the U.S. and its allies have imposed various sanctions that are ostensibly intended to limit targeted Russian companies from benefiting from the U.S. financial system, these efforts have not had the desired effect, producing modest results in both punishing the Putin regime and blocking Western capital from reaching blacklisted Russian companies. This is, in part, the result of existing sanctions policy failing to pursue key areas of Russian vulnerability for reasons that likely range from concerns emanating from Wall Street and the broader business community to those associated with trying to avoid escalating tensions.

One of the most crucial missing elements has been, and continues to be, the sustained and effective use of capital markets sanctions. Notwithstanding current policy, U.S.-sanctioned Russian companies still have a robust presence in our equity and debt markets. Indeed, most of these companies continue to be listed in prominent indexes and in ubiquitous index funds that are included in the investment portfolios of major state public employee pension systems and those of as many as 100 million Americans or more.

Even the average American retail investor finds themselves invested in these companies through accessing the same commonplace passive investment products. Sanctioned Russian companies have also been permitted to raise capital from U.S. investors through the issuance of bonds, although this is an area of access that has been targeted by existing sanctions (with various classes of sanctioned Russian companies subject to differing levels of restriction). U.S. investors, however, retain the right to hold stocks that were issued prior to the sanctions date, and, for most currently sanctioned, publicly traded Russian companies, there is no restriction at all on U.S. persons purchasing or trading in their stocks, regardless of when they were issued. The failure to target in a comprehensive and consistent manner this aspect of Russian access to the U.S. financial system represents a significant shortcoming in the efforts of U.S. policymakers to maximize their use of economic and financial leverage over the Kremlin. Accordingly, U.S. capital continues to play a significant role in propping up the Russian economy and military.

Based on data from the Moscow Exchange, investors described as emanating from "North America" account for over half of the foreign capital flowing into Russian stocks. European investors account for 26%. In the second quarter of 2019, U.S. fund managers reportedly invested $79.3 billion into Russia's publicly traded companies, an increase of 58% since 2015. Some reports claim even more significant amounts are invested in Russia than are being reported, as Western investors often use so-called "conduit" countries to invest in the Moscow stock exchange, which are not considered in this data.[2]

Inclusion of Sanctioned Russian Companies in U.S. Indexes

After the announcement of sanctions in 2014, MSCI, one of the leading U.S. index providers that set benchmarks tracked by trillions of dollars of funds under management, announced that it would continue to hold certain sanctioned entities in its Russia index, as doing so would not violate new regulations. They noted at the time:

> "… MSCI announced on August 8, 2014 that it would maintain Sberbank Russia Com (Rub), Sberbank Russia Pref (Rub) and VTB Bank (Rub) in the MSCI Russia Index until further notice, as the issues potentially resulting from the comingling of existing and new equity were not perceived as an immediate concern by most consulted market participants. MSCI also announced that it would not implement any increases in Number of Shares (NOS) or Foreign Inclusion Factor (FIF) for Sberbank Russia Com (Rub), Sberbank Russia Pref (Rub) and VTB Bank (Rub) until further notice."[3]

[2] https://www.forbes.com/sites/kenrapoza/2019/10/22/most-foreign-capital-flowing-into-russia-stock-market-is-american/?sh=68ea2fd899e1

[3] https://www.msci.com/documents/10199/c5409169-3e0c-4a7b-b2aa-ef8975e4979c

Other major index providers in the United States followed suit and continue to offer investment fund products that include publicly traded Russian companies that have been sanctioned by the U.S. government. A brief summary of the presence of some of these companies in major indexes (as well as an annotation of those that have issued bonds with the involvement of U.S. banks) is provided below.

Security Name	MSCI EM Index	MSCI ACWI Index	MSCI ACWI ex-U.S. Index	MSCI Russia	FTSE Emerging Index	FTSE All-World Index	Russian ADRs in OTC Markets	Issued Eurobonds since 2014
Gazprom	X	X	X	X	X	X	X	X
Sberbank	X	X	X	X	X	X	X	
Lukoil	X	X	X	X	X	X	X	
Novatek	X	X	X	X	X	X		X
Surgutneftegas	X	X	X	X	X	X	X	
Rosneft	X	X	X	X	X	X		
VTB Bank	X	X	X	X	X	X		
Transneft					X	X		
Gazprom Neft							X	

Inclusion of Sanctioned Russian Companies in U.S. Pension Funds

Nearly 21 million people participate in public pension funds in the United States, with 90% of those participating in state-administered plans.[4] Four of the largest state-administered pension funds in the United States (with an estimated total of $1 trillion in assets under management)

[4] https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-and-local-backgrounders/state-and-local-government-pensions

continue to hold shares in – or include investment exposure to – Russian sanctioned companies. Examples appear below.

California Public Employees' Retirement System (CalPERS)

Data as of June 30, 2020

Security Name	Shares	Market Value
Gazprom	14,517,298	$78,335,340
Sberbank	6,273,958	$71,393,525
Lukoil	1,118,702	$83,074,811
Novatek	251,317	$35,737,277
Surgutneftegas	1,679,533	$8,968,793
Surgutneftegaz	1,816,113	$8,880,793
Rosneft	2,747,769	$13,815,783
VTB Bank	6,005,865	$5,636,504

California Teachers' Retirement System (CALSTRS)

Data as of June 30, 2020

Security Name	Shares	Market Value
Gazprom	5,575,961	$30,222,000
Gazprom	1,837,386	$9,915,000
Sberbank	13,795,355	$156,991,000

Sberbank	4,330,659	$49,110,000
Lukoil	675,779	$50,183,000
Lukoil	1,168,792	$86,748,000
Novatek	113,422	$16,129,000
Novatek	27,299	$3,882,000
Surgutneftegas	101,302	$541,000
Surgutneftegas	402,736	$2,151,000
Surgutneftegaz	52,707	$258,000
Rosneft	304,291	$1,530,000

New York State Common Retirement Fund (CRF)

Data as of March 31, 2020

Security Name	Shares	Market Value
Sberbank	2,470,263	$23,541,606
Novatek	102,693	$11,840,503
Surgutneftegas	1,213,974	$5,190,953
Rosneft	849,857	$3,458,068
VTB Bank	317,289	$261,763

Florida Retirement System (FRS) Pension Plan

Data as of September 30, 2020

Security Name	Shares	Market Value
Sberbank	931,297	$10,944,974.87
Sberbank	3,485,976	$10,242,135.63
Lukoil	608,775	$34,949,772.75
Lukoil	16,977	$980,537.19
Lukoil	255,988	$14,785,047.72
Novatek	649,083	$373,828.48
Novatek	-	$265.38
Novatek	-	$292.95
Surgutneftegas	105,439	$470,532.08
Surgutneftegaz	2,821,400	$1,259,066.68
Rosneft	1,541,373	$7,615,307.44
Rosneft	4,660	$23,023.39
VTB Bank	515,770,000	$229,001.88

Russian Sovereign and Corporate Bonds

The continued market interest and investment in Russian bonds – both sovereign and corporate – right up to, and following, the latest round of U.S. sanctions, is another demonstration of how limited existing financial sanctions targeting Russia have been. As noted, while the new sanctions policy places further limitations on purchasing sovereign bonds in the primary market, it does not do enough to prevent the trend of investors around the world pouring into the bond issuances and the secondary market for this debt and that of many of its leading state-owned enterprises, including those that are technically under official American sanctions.

In 2020, for example, Gazprom raised one billion euros in euro-denominated bonds. One quarter of those investors were from Germany. UK-based investors accounted for 10-15%, France for 10-11%, and Switzerland for 6-7%.[5, 6] Russian sovereign bonds, in general, have also been extremely attractive for foreign investors, including in the United States.

In 2019, the U.S. Treasury Department's ten-year bond yielded 1.8% interest, while Germany's offered a negative return. Russian bonds comparatively look more attractive, with the 2027 bond paying 4.25% interest.[7] By the summer of 2020, investors held $43 billion worth of Russian sovereign bonds (OFZs), or around one-third of this debt.[8]

Because of their high yields compared to U.S. and European bonds, U.S. investors have a vested interest in continuing to access OFZs.[9] It was reported, for example, that the U.S. Department of Treasury has previously played a key role in voicing opposition when the question arose about restricting the ability of U.S. investors to participate in these bonds, claiming that restrictions would have a negative impact on domestic financial markets and on big energy and technology firms that have operations in Russia. For example, a 2018 report from the U.S. Treasury Department argued against expanding sanctions on Russian sovereign debt, stating that,

> "…the magnitude and scope of consequences from expanding sanctions to sovereign debt and derivatives is uncertain and the effects could be borne by both the Russian Federation and U.S. investors and businesses." [10]

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[5] https://www.reuters.com/article/gazprom-eurobond/update-2-gazprom-raises-1-bln-euros-in-eurobond-deal-idUSL8N2BW5O7
[6] https://www.reuters.com/article/gazprom-eurobond-idUSL1N2JV0OA
[7] https://www.forbes.com/sites/kenrapoza/2019/11/18/for-wall-street-russia-has-become-bullet-proof/
[8] https://www.reuters.com/article/us-russia-debt-analysis-idUSKBN2480K4
[9] https://www.wsj.com/articles/foreign-investors-flock-to-russian-government-bonds-11596619801
[10] https://www.bloomberg.com/politics/articles/2018-02-02/treasury-warns-of-widespread-effects-of-russian-debt-sanctions

As a result of these and other supposed market concerns raised primarily by sanctions detractors, the U.S. government has implemented a more limited set of sanctions than might otherwise be the case. Executive Order 13883, implemented in August 2019, for example, targeted the ability of Americans to hold "Russian sovereign" debt, but imposed two key limitations: 1) it only prohibited U.S. financial institutions from participating in future primary issuances; and 2) it only targeted Russian sovereign debt that was denominated in currencies that were not the ruble.[11]

Each of these were designed to minimize the impact on the U.S. investment community, but they simultaneously limited the impact on the markets' perception of "Russia risk" and, equally as important, on the pain imposed on the Kremlin. The recent set of U.S. sanctions targeting Russian sovereign bonds address only the latter limitation, additionally prohibiting the trading of ruble-denominated sovereign debt. Ultimately, whatever the reason, even the recently announced sanctions, characterized by the Biden Administration as "sweeping" in their effect, suffer from some of these same concessions.

As a result, these half-measures are likely to meet the same fate as their predecessors, failing to have a material effect on the secondary trading of Russian sovereign debt, failing to affect the stock holdings of certain sanctioned Russian enterprises, and not making it illegal to own previously issued Russian sovereign debt (therefore reinforcing the idea that a good return on investment can still be had through investment in these instruments, so long as one can avoid the repercussions of being directly involved in their issuances). Indeed, as mentioned above, in 2020, foreign investors held nearly one-third of domestic Russian bonds (with 8% held by U.S. investors).[12, 13]

Meanwhile, the Russian Central Bank uses funds from bond issuances to support domestic social programs, economic development, military modernization, research programs and the Russian security services. Although the main source of Russian state funding is taxes from oil, gas and mineral extraction, issuing sovereign bonds has helped the Kremlin to manage the effects of the volatility of global energy prices. Corporate bonds have also shielded state-owned enterprises from the adverse effect of sanctions and helped finance large energy infrastructure projects.

Recommendations

That sanctioned Russian companies continue to benefit from the U.S. capital markets is a glaring omission in U.S. policy that should be remedied. There is significant untapped leverage available by imposing tougher prohibitions on the ability of U.S. persons to hold the securities of these

[11] https://home.treasury.gov/news/press-releases/sm750
[12] https://www.wsj.com/articles/foreign-investors-flock-to-russian-government-bonds-11596619801
[13] https://acra-ratings.com/research/868

companies in portfolio (whether the result of primary issuances of corporate stocks and bonds or through secondary trades). U.S. sanctions policy also needs to target sovereign bonds to a more fulsome extent.

Doing so, however, may necessitate a scenario where those that have invested in Russian debt or equities experience some losses. Failing to show a willingness to absorb this cost (or to permit others to absorb it) will significantly undermine the idea that these assets carry substantial risk. At present, the market's perception of "Russia risk" is being actively suppressed by the concern held by the U.S. government that targeting Russia in this manner will actually cost someone money. Indeed, that is a fundamental point that has to be unabashedly reinforced.

As noted above, U.S. policymakers should look to recent restrictions placed on Chinese companies as a model for stricter and more effective capital markets sanctions. Most prominently, as referenced earlier, Executive Order 13959 – "Addressing the Threat from Securities Investments That Finance Communist Chinese Military Companies" – has prohibited U.S. persons from holding the securities (i.e., stocks and bonds) of companies designated by the U.S. Department of Defense as "Communist Chinese Military Companies" (CCMCs).

The Order also requires full divestment of all securities in these companies by U.S. persons by November 11 of this year and prohibits the inclusion of CCMCs in U.S.-based indexes and index funds.[14] In short, Executive Order 13959 targets Chinese companies with a number of the measures that have been held back with regard to Russia. The U.S. government should consider applying as a first step a similar approach to officially sanctioned Russian companies.

[14] https://home.treasury.gov/policy-issues/financial-sanctions/faqs/topic/5671