RWR Advisory Group

The Presence of Sanctioned Russian Companies in the U.S. Capital Markets

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Introduction

As the Biden Administration continues to emphasize the importance of using economic and financial tools to penalize the Kremlin for its invasion of Ukraine, the United States and allied countries have implemented a wide range of sanctions and other penalties targeting Russian companies and leaders. These measures extend far beyond those implemented in response to the invasion of Crimea in 2014, now including sanctions on the Russian central bank, the Ministry of Finance, and President Putin himself.

Within this mix, capital markets sanctions have been leveraged in an unprecedented fashion, now targeting select Russian state-owned companies and banks with tougher restrictions than have ever been leveled against them before. These sanctions prohibit any U.S. person from participating in new issuances of debt and equity securities by thirteen designated companies and banks. They do not, however, mandate the divestment of existing positions nor mention investor exposure via passive investment products such as index funds (although, within the past 24 hours, index providers have begun to voluntarily exclude a significant number of Russian companies).[1]

Russian Companies and the Sanctions Architecture of the NS-CMIC List

Such harsh divestment measures do apply, however, to Chinese companies that have been designated to the Non-SDN Chinese Military Industrial Complex (NS-CMIC) List, a process that was framed by amendments to Executive Order 13959, and by Executive Order 14032, issued in November 2020 and June 2021 respectively. In this manner, the

[1] https://home.treasury.gov/system/files/126/new_debt_and_equity_directive_3.pdf

unique NS-CMIC designation could lay down the architecture for how sanctions targeting Russian companies could be toughened further in the period ahead.

Executive Order (E.O.) 13959, which was expanded and superseded by E.O. 14032, prohibits U.S. investors worldwide from holding the securities (i.e., stocks and bonds) of certain Chinese companies – including by index funds and other passive investment vehicle providers. Moreover, these orders mandate divestment of existing positions in any securities of these entities within one year of their designation.

Targeting the ability of U.S. persons to trade in a company's securities in the secondary markets – rather than merely banning the purchase of its new equity issuances – is arguably a more disruptive path, ratcheting up significantly the perception of risk by market players. E.O. 13959 was strengthened in this regard, when it was subsequently amended to mandate divestment and prohibit passive investment exposure. Existing sanctions on publicly traded Russian entities could be strengthened in a similar way.

The Systemic Effects of Targeting Secondary Market Trading

While some may argue that this does not target the Russian companies as directly as it does their shareholders, the systemic effects of targeting secondary market trading in a company's securities is substantial and thus far underrepresented in U.S. economic and financial statecraft. Although thirteen Russian companies are now prohibited from raising capital from U.S. investors through the issuance of new bonds with a maturity longer than fourteen days, U.S. investors retain the right to trade and hold to maturity debt purchased before March 26, 2022 (thirty days after their designation). This includes the debt of Russia's largest state-owned companies and banks that often operate as mere extensions of the state and its treasury.

As the Russian war effort in Ukraine continues and the United States seeks to tighten economic restrictions, it is possible that attention will turn to giving Russian companies the same tougher treatment already given to certain Chinese companies. Until then, U.S. investors may still feel that they can ride out (or even profit from) the risk exposure of Russian companies and banks, a reality that enables such entities, even if severely battered, to benefit from the breadth and depth of the U.S. capital markets.

On July 1, 2021, foreign funds held 80.7% of all shares freely floated on the Moscow Exchange. Investors from the U.S. and Canada accounted for over half of foreign capital flowing into Russian stocks, while European investors accounted for 21% and U.K. investors for 22%.[2] Based on data from the Moscow Exchange, overseas investors owned approximately $86 billion of Russian equities at the end of 2021. *Bloomberg Intelligence* estimates that, as of March 1, 2022, funds based in the U.S. and Europe now own about $13 billion of stocks in recently sanctioned Russian companies.[3] This data does not include the significant amount invested in Russia using so-called "conduit" countries, like Cyprus, to invest in the Moscow stock exchange.[4] As such, the amount of foreign capital invested in Russian stocks could be even higher.

Exclusion of Sanctioned Russian Companies from U.S. Indexes

Following the plunge of Russian markets after the military invasion of Ukraine, index providers – who, thus far, have fallen outside the scope of the official investment bans – have been persuaded to rethink their decisions to include certain sanctioned Russian

[2] https://www.reuters.com/article/us-russia-moex/foreign-funds-now-own-81-of-all-shares-listed-on-moscow-exchange-bourse-idUSKBN2EZ1XU
[3] https://www.bloomberg.com/news/articles/2022-03-01/russian-markets-start-to-look-uninvestable-as-sanctions-bite
[4] https://www.forbes.com/sites/kenrapoza/2019/10/22/most-foreign-capital-flowing-into-russia-stock-market-is-american/?sh=68ea2fd899e1

companies in their products. Just yesterday, MSCI, a leading U.S. index provider setting benchmarks tracked by trillions of dollars of funds under management, announced that it was removing Russian companies from all their indexes. On February 28, preceding the announcement, the head of MSCI's Index Policy Committee called the Russian market "uninvestable," and openly discussed possibly removing the MSCI Russia Index and all Russian securities from its international benchmarks.[5]

The decision to remove Russian exposure appears to depart from MSCI's approach in 2014, following the invasion of Crimea, when sanctioned Russian entities remained in its indexes (doing so was deemed still legal and permissible). U.K.-based index provider FTSE-Russell joined MSCI in announcing the exclusion of all Russian securities from its products, , following JP Morgan's earlier announcement of the removal of Russia from two of its ESG bond benchmarks, as it continues deliberations over other products.[6] [7]

Whatever the rationale associated with these decisions, these extraordinary steps indicate the preparedness and ability of major market actors, not only to cease underwriting new issuances (as is now required by law), but also, in some cases, to go further and divest of –or exclude, in the case of index providers – high-risk, sanctioned Russian companies. In doing so, they are exceeding what is required by sanctions policy (in isolated circumstances), but also showing the feasibility of treating Russian companies similar to the way Chinese companies are treated by the NS-CMIC List.

While passive investment managers excising Russia-based securities from their products is a momentous occurrence and demonstrates how efficiently and expeditiously this can be done, when motivated, in this case, these decisions are, at least in part, based on the lack of returns and logistical difficulties that exist in investing in the Russian market. It is difficult to say how much of their decision is based on any analysis of regulatory and reputational risk associated with holding the securities.

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[5] https://www.reuters.com/business/exclusive-msci-says-removing-russia-indexes-natural-next-step-2022-02-28/
[6] https://www.reuters.com/business/jpmorgan-set-remove-russia-esg-bond-indexes-source-2022-02-28/
[7] https://www.reuters.com/markets/europe/msci-ftse-russell-remove-russian-securities-their-indexes-2022-03-03/

From a foreign policy perspective, the voluntary pull-back of Russia exposure in passive investment products is convenient in terms of the current U.S. strategy of penalizing the Kremlin in the markets, the impact is likely to be less sustained than if it was the result of sanctions targeting the secondary markets.

Assets in U.S. passively-managed global equity funds (such as ETFs and index funds) are estimated to hold around $1.67 trillion, compared to $2.36 trillion under active management. This ratio is even more pronounced in global fixed-income funds, where passively managed funds account for just over 30%.[8] Active managers retain the ability under the current Russian investment ban to trade existing debt and equity of the designated companies, and have both far more assets under management as well as more agency in designing investment strategies intended to ride out or profit from the risk associated with Russian securities.

The Presence of Sanctioned Russian Companies in U.S. Pension Funds

Several U.S. state treasurers and members of public pension system boards have similarly made comments and pledges over the past week responding to pressure over their funds' investment exposure to Russia. Although some states had already divested significant portions of their Russian investments, particularly holdings of Russian sovereign bonds, following Russia's invasion of Crimea prior to 2020, that trend did not gain broad traction outside of a few instances. Already in the past week, however, there has been state legislation introduced in New Jersey, California, Georgia, Pennsylvania, and Illinois requiring that the states excise Russian debt and equity from public pension funds.[9] Virginia, Colorado, and Connecticut were the first states to explicitly pledge

[8] https://www.bloomberg.com/professional/blog/passive-likely-overtakes-active-by-2026-earlier-if-bear-market/
[9] https://www.reuters.com/markets/europe/exclusive-connecticut-treasurer-orders-pension-funds-divest-russian-assets-2022-03-01/

Russian divestment.[10] [11] [12] Other public pension systems, including those in New York and California, have stopped short of coming out in favor of divestment, although pressure from their constituents as well as loss of liquidity and viability in the markets will almost surely continue to mount in the coming days and weeks.

The investments of public university endowments are likely to come under more scrutiny as well, as divestment campaigns targeting Russia accelerate. With a reputation for non-transparency concerning investment holdings, momentum on this topic will likely put an additional strain on the investment policies of university boards.

Nearly 21 million people participate in public pension funds in the United States, with 90% participating in state administered plans.[13] Four of the largest state-administered pension funds in the United States (with an estimated total of $1 trillion in assets under management) continued to hold shares in – or included investment exposure to – sanctioned Russian companies as of June 2021. Examples of public pension holdings appear in Appendix I.

Restrictions on Russian Sovereign Debt

Elsewhere in the realm of capital markets sanctions, days prior to the invasion, the Biden Administration prohibited American investment in all ruble- or foreign currency-denominated Russian sovereign debt. The measure strengthened a prohibition from April 2021 that focused strictly on primary markets purchases, now including the ability to trade in such debt on the secondary markets as well.[14] Like the investment

[10] https://www.reuters.com/markets/europe/exclusive-connecticut-treasurer-orders-pension-funds-divest-russian-assets-2022-03-01/
[11] https://www.institutionalinvestor.com/article/b1wz4ylj4lt7cn/Asset-Owners-Move-to-Divest-From-Russia-After-Ukraine-Invasion
[12] https://www.thecentersquare.com/colorado/colorados-public-pension-fund-withdrawing-7-2m-from-russian-bank-after-ukraine-attack/article_c5f46e5a-98cd-11ec-af35-73db852560dc.html
[13] https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-and-local-backgrounders/state-and-local-government-pensions
[14] https://home.treasury.gov/system/files/126/russia_directive_1a.pdf

restrictions on new corporate debt and equity issuances, however, the latest measures do not prevent investors from holding bonds purchased before March 1, 2022. In other words, these sanctions do not require divestment in the manner that is, again, called for in the case of NS-CMIC designated Chinese companies.

With the absence of any divestment mandates, U.S. investor exposure is locked in at existing levels (until these bonds mature). In November 2021, foreign investors held 20.5% of Russian government debt. By December 2021 this totaled nearly $64 billion with $20 billion in Russian Eurobonds and $31 billion in OFZ government bonds, according to Institute of International Finance and Moscow Exchange data. The top overseas holders of Russian debt are BlackRock Inc., Capital Group Companies and Legal & General Group Plc – with BlackRock having about $1.5 billion of $33 billion of bonds outstanding.[15]

Bottom Line

Given the stated desire of the Biden Administration to levy the most severe possible economic and financial penalties against the Russian government in response to the invasion of Ukraine, the disparity between the approach taken to target certain Chinese military companies and human rights violators versus that taken to target Russian entities is noteworthy. Whereas these Chinese companies are set on a path of divestment and prohibition from trading in the secondary markets, sanctioned Russian companies (even those hit with capital markets sanctions) are not.

Although mandating their divestment in addition to blocking primary market purchases of new shares would likely impose additional losses on existing shareholders, it is the chilling effect on the markets and the secondary orders of magnitude that this creates for the Kremlin that makes the option potentially potent. Demonstrating an unwillingness to absorb these costs (or to permit others to absorb it) potentially suppresses the overall

[15] https://www.bloomberg.com/news/articles/2022-02-25/blackrock-among-russia-bond-holders-tangled-in-15-billion-rout

level of risk and undermines the idea that investing in U.S. sanctioned Russian companies will indeed come at a financial cost.

Whether these steps are being held in reserve or simply seen as ill-advised remains to be seen, but the gap in treatment remains a potential piece of unused leverage that could soon emerge as policy.

Appendix I.

California Public Employees' Retirement System (CalPERS)

Data as of June 30, 2021[16]

Security Name	Shares	Market Value
Gazprom	25,012,664	$143,315,030
Sberbank	23,934,978	$167,210,877
Lukoil	1,184,965	$109,724,312
Novatek	245,263	$50,717,220
Surgutneftegas	42,630,936	$42,302,080
Rosneft	3,624,608	$28,146,481
VTB Bank	345,096,302	$7,442,022

California Teachers' Retirement System (CALSTRS)

Data as of June 30, 2021[17]

Security Name	Shares	Market Value
Gazprom	7,411,708	$56,533,669
Lukoil	5,392,379	$195,776,027

[16] https://www.calpers.ca.gov/docs/forms-publications/annual-investment-report-2021.pdf
[17] https://www.calstrs.com/sites/main/files/file-attachments/calstrsinvestmentreports2021.pdf?1640635684

New York State Common Retirement Fund (CRF)

Data as of March 31, 2021[18]

Security Name	Shares	Market Value
Sberbank	3,272,931	$50,423,920
Novatek	54,374	$10,738,865
Surgutneftegas	1,412,739	$6,343,198
Rosneft	1,134,183	$8,576,692

[18] https://www.osc.state.ny.us/files/retirement/resources/pdf/asset-listing-2021.pdf

Appendix II

U.S. Designations of Russian Companies

Company Name	Publicly Traded	EO 14024, D.3	SSI	Entity List
AlfaBank		X		
Alrosa	X	X		
Credit Bank of Moscow	X	X		
Gazprom Neft	X	X	X	X
Gazprom	X	X	X	X
Gazprombank	X	X	X	
Lukoil	X		X	X
Novatek	X		X	
Rosneft	X		X	X
Rostec			X	
Rostelecom	X	X		
RusHydro	X	X		
Russian Agricultural Bank		X	X	
Russian Railways		X		
Sberbank	X	X	X	
Sovcomflot	X	X		

Surgutneftegaz	X		X	X
Transneft	X	X	X	
VTB Bank	X		X	

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