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INTRODUCTION

As tensions continue to mount along Ukraine's borders, it is past time to take stock of what non-military tools the EU and NATO have at their disposal, a process presently underway. It is crucial that the U.S. and European nations clearly communicate the prospective costs to the Kremlin associated with a second Russian military incursion, otherwise this exercise will have insufficient deterrence value. Thus far, it is quite apparent that the allies have not achieved "critical mass" on menacing economic and financial sanctions, as Moscow continues to ramp up its military threat.

One reason that the Kremlin remains unconvinced that it faces draconian penalties in the economic and financial domain is what it does not see: active allied planning for capital markets sanctions against Russia's most prominent publicly traded companies in allied markets. It should be self-evident that NATO countries should not permit scores of millions of unwitting retail investors in their member states to continue funding the same companies that the U.S. and some other governments sanctioned in 2014 – and perhaps will again in 2022.

In reviewing all of the notional lists appearing in the media of potential economic and financial sanctions against the Kremlin in the event of a second military invasion of Ukraine, nowhere can be found the expulsion of already sanctioned Russian companies from the US and allied capital markets – despite it being a highly effective and necessary sanctions tool. At most, there has been some muttering about a prohibition on the purchase and holding of Russian sovereign bonds (including via the secondary markets) – an important step, but far too limited.

There are presently eight major Russian companies sanctioned by the United States for Russia's 2014 invasion that are presently included in the investment portfolios of well over 100 million unknowing European and American retail investors. Beyond sanctions imposed and administered by the U.S. Treasury Department's Office of Foreign Assets Control, half of these eight companies also appear on the Commerce Department's "Entity List", basically prohibiting the sale of American equipment and technology to enterprises appearing on the list because of their egregious human rights and national security abuses.

These companies are:

Gazprom*
Sberbank
Lukoil*
Novatek
Surgutneftegaz*
Rosneft*
VTB Bank
Transneft.

* Denotes companies that are also on the US Entity List

Should a second invasion take place, failure to expel these companies forthwith from allied capital markets and make it illegal for U.S. and allied investors to hold the securities of these companies anywhere in the world would further embolden the Kremlin and signal a glaring lack of resolve to defend our common security, fundamental values and retail investors.

MECHANICS

The majority of allied investors holding the stock of sanctioned Russian enterprises do so through index funds and other passive investment vehicles, particularly Exchange-Traded Funds (ETFs). Such index funds are derived from the products of major index providers such as MSCI, FTSE-Russell and S&P Dow Jones Indices, which often include these companies' stocks in their emerging markets and international indices. Passive investment products – notably Exchange-Traded Funds – benchmarked against these indices provide no disclosure whatsoever concerning the material risks associated with their being officially sanctioned by the U.S., and in half the cases twice (i.e., OFAC and Entity Lists),

Investment managers are generally motivated to purchase and hold risky Russian stocks and bonds because of the higher rates of profit they offer compared to their lower-risk, lower-return Western corporate counterparts. This risk/reward tradeoff is particularly evident in the bond markets.

U.S. Treasury bills and the German bund serve as benchmarks for low-yield, minimal-risk bonds for the U.S. and European markets, respectively, and both currently offer interest rates near zero on 10-year bonds, suggesting virtually no possibility of default. Bonds issued for the same term by the Russian government yield interest of over 9%, indicating the extent of the reward the government must offer to compensate for its default risk and to lure yield-hungry investors. This narrow focus on maximizing profits (and fees) has driven many investment managers into Russian markets, despite the risk to their corporate brands and reputations.

PRESENCE ON KEY EUROPEAN EXCHANGES

These same Russian stocks and bonds are being traded in European capital markets. In reviewing European exchanges, our research findings were as follows:

Exchange	Direct Equity Trading in Sanctioned Russian Companies (ADRS)	Russian Sovereign Bonds	MSCI EM Index	MSCI ACWI EX-U.S. Index	MSCI ACWI Index	MSCI Russia	FTSE Emerging Index	FTSE All-World Index
Borsa Italiana – Milan		✓	✓		✓	✓	✓	✓
Frankfurt Stock Exchange	✓	✓	✓	✓	✓	✓	✓	✓
Euronext Paris					✓	✓	✓	✓
London STock Exchange	✓	✓	✓	✓	✓	✓	✓	✓

It is not only the more established and larger European capital markets that have considerable risk exposed to publicly traded Russian companies. The Czech pension funds also have holdings in MSCI indices, including these U.S.- sanctioned Russian enterprises.

Czech Pension funds such as the "*Dynamic Participating Fund of Supplementary Pension Savings with State Contribution*" or "*Allianz Dynamic Participating Fund*" and "*Allianz Balanced Mutual Fund*" have holdings in Russian tainted MSCI indices. This means that a sizable number of Czech investors (approximately 1.4 million) have had their savings partially invested in these sanctioned Russian companies.

PRESENCE IN THE U.S. CAPITAL MARKETS

The visual below illustrates how widespread these sanctioned Russian equity holdings are in U.S. exchanges:

Security Name	MSCI EM Index	MSCI ACWI Index	MSCI ACWI ex-U.S. Index	FTSE Emerging Index	FTSE All-World Index
Gazprom	✓	✓	✓	✓	✓
Sberbank	✓	✓	✓	✓	✓
Lukoil	✓	✓	✓	✓	✓
Novatek	✓	✓	✓	✓	✓
Surgutneftgas	✓	✓	✓	✓	✓
Rosneft	✓	✓	✓	✓	✓
VTB Bank	✓	✓	✓	✓	✓
Transneft				✓	✓

CONSEQUENCES OF GRANTING RUSSIAN SECURITIES A "FREE PASS"

Having effectively ruled out any direct military intervention to help counter a Russian invasion of Ukraine via NATO or other means, the allies must rely on non-military deterrence efforts and/or penalties. Should allied policy makers choose not to expel the aforementioned U.S.-sanctioned Russian companies and sovereign bonds from European and American exchanges, it would, in effect, decouple access to Western capital from even flagrant military aggression by an adversary nation. Imagine, for example, the signal sent to Putin's closest axis partner, President Xi, with respect to the latter's malevolent intentions toward Taiwan. Put simply, there are very few, if any, more feared or effective policy tools in the allies' economic and financial arsenal than capital markets sanctions, particularly with regard to the United States.

Why would the U.S., NATO and the EU stop short of cutting off Russia's corporate access to allied capital markets, especially already sanctioned Russian companies? Are they merely waiting for the moment an invasion of Ukraine actually begins, or does it denote greater interest in protecting Wall Street fees and profits (and Europe's Wall Street equivalents) than our common security, fundamental values, and retail investors? The sad answer is that neither the U.S. nor the EU appear ready to make use of serious capital market sanctions regardless of the level of Russian aggression.

Hopefully, this grim prediction will be proved wrong. One thing is fairly certain, however, that a "free pass" permitting these Russian corporate "bad actors" to continue to enjoy the fundraising and other privileges of trading on Western capital markets – despite a hostile military foray – would lead to the popping of champagne corks in Beijing, Moscow, Tehran and Pyongyang over this validating display of the West's greed triumphing over international security and human freedoms.

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