



CORPORATE
GOVERNANCE
AND ECONOMIC
GROWTH
IN RUSSIA

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The National Council
on Corporate Governance

CORPORATE GOVERNANCE AND ECONOMIC GROWTH IN RUSSIA

Moscow, 2004

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**Corporate Governance
and Economic Growth in Russia**

(in Russian and English) /

Igor Belikov, Evgeny Gavrilentov,
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The purpose of this report is to summarize the recent developments in Russia's corporate sector and related changes in corporate governance. The report shows an important progress in Russian companies' practice and legislation. There is growing understanding in the government and in the business community that shared values and common principles with respect to corporate governance are essential for maintaining long-term growth and investment. The report also identifies key avenues for future work on improving corporate governance.

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PREFACE

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As Co-Chairman of The Conference Board's Commission on Public Trust and Private Enterprise, I am pleased to write this preface to the National Report on Corporate Governance and Economic Growth in Russia. In the United States we learned all too well the disastrous economic fallout of failed corporate governance practices. Along with my Co-Chair John Snow, formerly Chairman and CEO of the CSX Corporation and currently United States Secretary of the Treasury, we took the initiative and formed a group of distinguished leaders from the business, institutional investor, regulatory and academic sectors to develop a series of best corporate governance practices which, when voluntarily implemented by businesses, would supplement a host of regulatory and legal actions being undertaken elsewhere by our government. Our objective was to encourage certain elements of the private sector to change their negative approaches to corporate governance for the benefit of the economy as a whole, and, therefore, for their own benefit as well.

The National Report correctly points out the importance of collaborative corporate governance actions by corporations, investors, and the government as they

impact Russia's future development. The thrust of the report is absolutely correct when it describes the important role that effective corporate governance can play in fostering economic growth and in promoting a responsible market economy. Further, the report describes how long-term economic development can be improved by strengthening disclosure to provide greater transparency. It chronicles the abuses which have occurred, recognizing that any economy must grapple with the mistakes of the past to enable it to move forward to build an institutional, financial, and informational infrastructure that will meet the needs of the business and investor community both on a domestic and international financial market basis. We firmly believe that it is in the interests of the global economy that Russia takes these important steps, and we applaud your efforts to this end.

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Hon. Peter G. Peterson
New York City, April 29, 2004

A handwritten signature in black ink, appearing to read "Peter Peterson". The signature is written in a cursive, flowing style.

EXECUTIVE SUMMARY

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I. INTRODUCTION

1.1. This report summarizes conclusions regarding the importance of corporate governance in Russia. It outlines the recent actions of companies and the government in this area, and the measures still needed to be taken.

An effective approach to corporate governance by the government, by companies and by investors is necessary for the future development of Russia's economy as well as for the integration of Russia with the global economy itself.

1.2. At the 2003 G-8 summit in Evian, the leaders agreed that corporate governance plays a very important role in fostering economic growth and in promoting a responsible market economy*. This declaration has supported the Organization for Economic Cooperation and Development and the International Organization of Securities Commissions in their efforts to develop and disseminate advanced standards of corporate governance.

* Fostering Growth and Promoting a Responsible Market Economy – A G8 Declaration, 2003 G8 Summit, Evian, France.

1.3. The principles underlying long-term economic development include the strengthening of market discipline, improved business transparency through better disclosure, effective regulation and corporate social responsibility. We agree that timely and accurate information helps shareholders to evaluate the strategic decisions and implementation of management and Boards of Directors and to, therefore, achieve better returns on their investments. Effective corporate reporting also will help governments (and regulators?) monitor markets, identify risks and impose appropriate regulation to encourage growth and fair competition.

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2.

CORPORATE GOVERNANCE AND ECONOMIC GROWTH IN RUSSIA

2.1. Following a long decline in the 1990s, the Russian economy has been strongly rebounding. In the past five years, the nation's GDP rose an average of 6.8% annually, thus increasing actual GDP by more than one-third. The Russian economy became more attractive for investment and two leading rating agencies raised Russia's sovereign rating in 2003. Industrial and financial companies alike have been actively borrowing on foreign markets. Capital outflows in 2003 declined significantly and the Russian stock market has been rising rapidly. Positive changes in the Russian economy have been in part the result of the government's economic policies that included:

- Reforming the taxation system
- Making public expenditures more efficient
- Enforcing tax, budget and land codes
- Passing legislation for pension and power sector reform, and to lower administrative barriers for small business.

Initial positive changes regarding corporate governance were seen in the approval of the Code of Corporate Conduct and in other efforts taken by the government, investment community and supported by

international organizations, particularly the OECD and the World Bank. Major Russian companies became more transparent, disclosing the identities of their shareholders and making their financial reporting consistent with International Accounting Standards.

2.2. These are encouraging developments, but further structural changes in the economy and industrial sectors will be required. High growth rates in 1999-2003 were mostly driven by higher capacity utilization. This was brought about by the devaluation of the ruble, which turned domestic demand toward domestically produced goods. In the later period, revenue from increased oil prices pushed up both consumer demand and investment activity. Economic growth relied mostly on the expansion of this domestic demand and increasing capacity utilization to meet it. But this cycle had run its course by the end of 2003. Today, demand has shifted from cheap goods to more expensive, higher-quality goods and services. Russian companies have difficulty competing with foreign producers in this segment. Future growth is dependent upon more sophisticated companies, capable of producing competitive goods for the domestic market and export. Investment to create these facilities will be the catalyst of economic growth, provide diversification and reduce dependence on world energy and natural resource prices.

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2.3. Russia's fundamental strategy must be to re-allocate investment from resource sectors to manufacturing, incentivize companies driven by knowledge and innovation, and re-build the country's intellectual capital. To achieve this goal, Russia will need to develop a dynamic private financial sector, able to borrow on world markets and meet the country's rapidly growing demand for debt and equity.

2.4. To create favorable conditions for starting new businesses and expanding existing ones, the following measures should be taken:

- Lower barriers for private enterprise, cut market entry costs and reduce costs of business transactions
- Cut government intervention in the economy and eliminate excessive customs and foreign exchange regulations and control

- Build a more robust institutional, financial, and informational infrastructure to meet the needs of business
- Support a legislative and regulatory system capable of ensuring a sustainable business environment.

The crucial role for the Government is to guarantee a level playing field for all market participants, and facilitate integration of the Russian economy with the global economy.

2.5. Russia's economic policy must promote a guarantee of rights regarding private property and the privacy of information. Effective corporate governance is essential to these rights. It requires the highest standards of business ethics. It requires that all public companies have an effective and empowered board of directors and provide information about operations and management decision-making that is accessible and transparent.

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3. CORPORATE GOVERNANCE: LEGISLATION, REGULATION AND ENFORCEMENT

3.1. Re-distribution of ownership in Russian companies in the 1990s took unfair forms in many cases. This was largely due to an immature Russian legal and judicial system that allowed unwarranted dilution of shareholder capital, squeezing out of shareholders, asset stripping, hostile takeovers without proper compensation and manipulation of shareholder meetings. The court system failed to protect the interests of shareholders, resulting in an unfavorable investment climate in Russia.

3.2. Emphasis was placed on corporate governance in the regulation of joint-stock companies after 2000. Foreign investors played an important role in this by urging the acceptance of generally accepted principles of corporate governance. This discussion resulted in the passage of amendments to the federal law On Joint-Stock Companies and in drafting the Code of Corporate Conduct. These amendments have broadly resolved problems, such as the dilution of shareholder capital and squeezing out of shareholders. They also prohibited the manipulation of procedural rules during shareholder

meetings and codified more explicit rules for insider transactions.

3.3. One amendment bans extending the general meeting's authority beyond statutory limits. This makes the role of the board of directors extremely important. The law requires cumulative voting for electing the board of directors, regardless of the number of its stakeholders. This makes it easier for minority-sponsored candidates to be elected to boards and to influence board decisions. Coupled with the requirement to limit management representatives on boards and recommendations on the number of independent directors, these measures will be instrumental in building good corporate governance bodies.

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3.4. Russian legislation focuses on disclosure of information as a key element of corporate governance. Confidence of shareholders and other stakeholders in joint-stock companies is based on equal access to information about the company. The current financial and non-financial disclosure requirements by Russian joint-stock companies are consistent with EU and IOSCO requirements. Furthermore, Russian companies will move to international accounting standards within a few years.

3.5. Russian legislation has also increased the accountability of company executives. Several new types of *corpus delicti* related to executive performance were included in criminal legislation, such as negligence in disclosure, abuse of authority, and commercial bribery. Criminal prosecution should deter future corporate governance offences.

3.6. Although the legislative framework and court practices have been significantly improved, there are several outstanding needs:

- Improve public disclosure of the real owners and beneficiary owners of all joint-stock companies. This will require strengthening the enforcement authority of the newly established Federal Service on Financial Markets (FCFM)*

* In accordance with the Decree of the President of the Russian Federation, the Federal Commission for Securities Markets (FCSM) was dissolved. The FCSM's regulatory and supervision functions have been transferred to the Federal Service on Financial Markets (FSFM).

- Separate the jurisdictions of the Supreme Arbitration Court and the Supreme Court in disputes related to joint-stock companies
- Enforce prohibitions against insider trading
- Establish the principles of reasonableness and good faith in judging the actions of managers, members of management boards and boards of directors.

4. CORPORATE GOVERNANCE PRACTICES IN RUSSIAN COMPANIES

4.1. A growing number of Russian companies have begun moving from short-term strategies aimed at controlling ownership to philosophies that emphasize the long-term development of their business and focus on greater political stability, sustainable growth and becoming more competitive. Some have become leaders in their industries and listed on the Russian and international stock markets. To attract investors, they are now making significant advances in corporate governance. These business leaders are gradually moving from operating management to strategic management. CEOs in some of the largest companies are relinquishing their positions to become chairmen of their boards and focusing on the governance of these companies.

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4.2. The owners and top managers of leading Russian companies realize that effective corporate governance can achieve a sustainable balance of different stakeholders' interests. Positive changes are visible in disclosure practices, and the conduct of general meetings of shareholders. Most large Russian companies and many medium-sized ones have separated the positions of CEO and board chairman. Boards of directors, particularly in leading companies, have strengthened their role in management oversight. This is particularly true in the approval of corporate strategy, implementation oversight, approval of large transactions and restructuring. A number of companies have established special internal committees, such as audit, corporate governance, nomination, and compensation committees.

4.3. Positive changes have been made in the past few years in implementing the legal rights of shareholders concerning significant equity and debt transactions, restructuring, consolidation, mergers and acquisitions and payment of dividends. A system of dispute resolution is being built in Russia. The Russian Union of Industrialists and Entrepreneurs (RUIE) adopted the Charter of Corporate and Business Ethics and established an arbitration and intermediation panel. Companies as well as industry and professional associations have stepped up their activism in drafting internal codes of best practices in corporate governance, business ethics and the social responsibility of business. In 2003, RUIE established a committee for social responsibility of business to promote international standards and rank the performance of Russian companies against social and environmental responsibility criteria.

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4.4. Building independent and responsible boards of directors is a key task in Russia. Boards must become effective corporate governance bodies, taking responsibility for their decisions, opposing undue influence by large shareholders, and finding sound solutions to potential conflict of interests. To accomplish this, several outstanding actions must be taken:

- Develop the company's information policy standards
- Increase the scope of disclosures
- Establish professional standards and ethical norms for board members
- Ensure that all directors receive all relevant company information.

Boards must interpret and apply these new governance principles for their companies. Majority shareholders and the government must strengthen the accountability of boards of directors, and discontinue the practice of imposing undue influence on board members.

4.5. Positive changes in disclosure practices must be expanded beyond a relatively small group of Russian companies. International cooperation on regulation of foreign business needs to be expanded. Foreign

institutional investors should be consistent and insistent in requiring public disclosure of information about shareholders and beneficial owners.

4.6. Large assets still remain under federal and municipal ownership. Representatives of federal and regional governments in joint-stock company management and governance bodies must improve performance. Effective corporate governance must become their highest priority. This is especially important in companies whose strategy is to use the public markets to raise capital.

4.7. The domestic stock market is relatively narrow, and this strongly inhibits the development of Russia's economy. The priority task for regulators and the business community is to help to establish a significant group of companies that are attractive to potential investors because they have been managed to the highest corporate governance standards. A breakthrough beyond the present limited group of 10–15 "blue chip" companies will give investors much broader opportunities for risk diversification and make the Russian market more liquid and sustainable.

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CORPORATE GOVERNANCE AND THE INVESTMENT COMMUNITY

5.1. Domestic and foreign investors' confidence in the Russian stock market strengthened over the past few years. The Russian Trading System (RTS) Index (the 59 most liquid companies) rose by 58% during 2003 and the Moscow Interbank Currency Exchange (MICEX) Index (12 companies) increased by 61% during 2003. Total market capitalization increased over \$170 billion (RTS capitalization plus capitalization of Gazprom). The 2003 trade volume of RTS, MICEX, London, New York and Frankfurt Stock Exchanges (depository receipts to the Russian issuers' shares) was about \$110 billion, up 69% versus the previous year. Nevertheless, despite this appreciation, new offerings remained at a low level, both in capital raised and in the number of placements.

5.2. Over 80% of investors polled by Standard & Poor's believe that the quality of a company's corporate governance is the main factor influencing investment decisions. Strategic investors have similar views. Standard & Poor's annual surveys show that the level of corporate transparency closely correlates with market value. Companies that are more transparent for investors and openly share corporate information have a higher market value.

5.3. Corporate conduct means more for investors than a set of standard procedures that separate different decision-makers' responsibilities in a company. They expect a culture of reasonableness and fair play. They expect honesty and forthrightness in a company's behavior in the securities markets and in business. This includes objective dispute and conflict resolution; openness and goodwill toward investors; strict control and reliance on generally accepted accounting practices. Absent this culture, no confidence between participants in the investment process is possible and investment in Russian companies will be hampered, entailing high cost due to perceived excessive risks. On the other hand, with this culture appropriate corporate relationships, including that with government as well as investors, can be established.

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5.4. A main characteristic of the Russian stock market is the high concentration of ownership and a small free float. This low liquidity results in high volatility of Russian stocks. Also, due to this concentration and ineffective governance, minority shareholders can be vulnerable to a loss of all or a large share of their assets due to:

- Asset stripping through transfer pricing
- Sale of assets below market prices
- Defaulting on obligations where assets are used as security.

5.5. In this environment, institutional investors play a more active role than in the West. Foreign minority shareholders can better assess risk and potential returns by being proactive in corporate governance. At the same time, they must be cognizant that sitting on

the board of directors can generate a conflict of interest. If the director who represents minority shareholders is a portfolio investor, that person could use insider information to unfair advantage.

5.6. Investors usually understand a company's reasons not to pay a dividend but use all or most of its profits for development. At the same time, only one fifth of investors polled by Standard & Poor's thinks that dividends are in reasonable proportion to profits in their Russian investments. Investors view inadequate disclosure as another major problem. This strongly inhibits timely decisions to discontinue their investments or take other measures to limit losses.

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5.7. Investors believe criteria for compensating management and board members should be revised. They believe compensation should (i) link personal interests with the interests of all shareholders, and (ii) promote the long-term growth of the company's value. As for enforcement, investors seek shorter litigation procedures in court and adequate compensation of damages.

Improvement of corporate governance should help create the conditions for protection of private property, investor rights and interests, and help build competitive national corporations that will be attractive investments and the locomotives of economic growth in Russia.

6.

CONCLUSION

6.1. The G8 declaration in Evian set the agenda for governments and the business community to institute the best corporate governance practices. Sustainable growth requires responsible behavior in business. In this context, companies' voluntary initiatives to enhance business, social and environmental responsibility will play a notable role.

6.2. Russia is committed to becoming integrated with the global economy. This will require measures to fight financial crime, money laundering and financing of terrorism. It intends to join other countries in protecting the rights of investors, better coordination of regulation

and improved enforcement practices. Integrity, quality and accessibility of financial and other information must be major factors of market transparency.

6.3. Corruption remains a main obstacle for economic and social development. Visible and sustainable progress in suppressing corruption can be achieved only if governments, international institutions, the private sector and civil society all take concerted and coordinated actions.

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1 THE ROLE OF CORPORATE GOVERNANCE IN ECONOMIC GROWTH IN RUSSIA

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I.I. ASSURING SUSTAINABLE GROWTH IN THE RUSSIAN ECONOMY

In the 2003 annual address to the Federal Assembly, the President of the Russian Federation set a goal of doubling Russia's GDP over the next decade with an average annual growth rate exceeding 7%. Experience over the last decade indicates this is achievable, but changes in the Russian economic model will be required.

Following a long economic decline in the 1990s, when GDP dropped by more than 40%, the Russian economy has since rebounded strongly. The average annual growth rate in the past five years reached 6.8% and, as a result, GDP has increased in volume by more than one-third.

Several Factors Led to an Economic Upturn After the 1998 Crisis:

- Devaluation of the ruble increased demand for Russian goods
- Foreign demand raised GDP and consumer incomes
- Increased consumer demand drove much higher capacity utilization, corporate profits, and worker incomes

- Increased oil prices boosted consumer incomes further and corporate investment expanded, continuing the economic stimulus
- Oil exports grew and government and business began re-allocating foreign exchange proceeds to other industrial sectors, expanding the economic base.

Russian companies were demonstrating their ability to meet the demand for basic goods, but the domestic market was changing.

By 2002, incomes had grown rapidly and demand quickly shifted from relatively simple, cheap goods to more expensive, higher-quality goods and services. Production facilities were operating at full capacity, and some worried that this could slow economic growth.

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But there were other more important threats to continued economic expansion. Simple domestic demand for basic products has natural limits. Such demand alone could not generate growth projections.

GDP was continuing to grow, but manufacturing was slowing, and growth of imports exceeded economic growth. The cause was not the appreciation of the ruble, but uncompetitive Russian producers.

Changes Needed for Continued Growth

The long-term economic development strategy drafted by the Russian Federation calls for building a diverse and dynamic economy, one less dependent on the fluctuations of world energy and resource prices. Radical modernization of the economy's structure and investment climate are the government's highest priorities to achieve this goal. The government's first steps are to assure a stable business environment, simplified and less burdensome tax system, lower barriers to entry, a level playing field for all participants, and guaranteed rights of ownership.

The Russian government and business community are committed to upgrading the country's industrial and technological framework, improving its business culture and raising the quality of corporate governance and public administration.

These joint initiatives will lead to a favorable investment climate essential to achieving the growth projections noted above.

I.2.

THE CATALYSTS FOR LONG-TERM GROWTH AND MODERNIZATION

Economic development is driven by the dynamics of labor resources, fixed assets and total factor productivity (TFP). The latter usually embraces R&D achievements, such as changes in production effectiveness, accumulation of knowledge and information technologies. Productivity will remain the main driver of the Russian economy in the years to come. It is the only realistic way to sustain high growth rates in present-day Russia.

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Understanding Differences Between Asian and Russian Development

Russia will not likely take the same development path as Asian countries took in the past decades. Accumulation of fixed assets made the largest contribution to Asian countries' economic vitality. Their national policies were aimed at developing large national companies and making capital readily and easily accessible. In addition, the accelerated economic growth in South East Asian countries was strongly supported by the expansion of the labor supply that resulted from population growth and migration from rural communities to cities. Productivity was also on the rise, albeit at a slower pace.

The Asian crisis of 1997-1998, however, became a vivid example of the vulnerability of an economic system that ignores and, in some cases, openly flaunts the principles of corporate governance and corporate transparency. In doing so, moreover, these economies lost the "safeguard" that sound corporate governance practices provide in times of economic turmoil and upheaval.

Expansion of human capital cannot strongly contribute to Russia's economic rebound, as its workforce is expected to be limited in the long run. Russia cannot rely on a large influx of cheap labor from rural

communities, as did China, Korea, and other Asian countries. Russia's rural population (slightly above 20%) is still large by European standards, but much below that of Asia in the early period of its accelerated growth. Furthermore, the demographic situation in Russia will worsen in the years ahead. The labor supply is expected to shrink and the demographic load (number of dependents per every 1,000 persons in the workforce) will increase due to an aging population. This will provoke higher social expenditures and limit government economic stimulus.

Improving Productivity Must Be the Objective

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Post-crisis growth in Russia was driven by increased productivity. The average annual GDP growth from 1999 to 2003 was 6.8%, while fixed assets and employment only rose by an average of 0.5% a year.

To grow fixed assets by 0.5-1% a year, investment must increase by at least 10% annually. Despite this, capital accumulation will likely rise at a much slower pace, even if investment increases by 10%. Employment levels will not change significantly, and it is possible that growth will not exceed 0.5% a year. In this case, annual TFP growth could reach 5.5-6.5%, which will generate economic growth required for doubling GDP over 10 years. This will only be possible if investment is not limited to the energy sector alone, but also is focused on industries that add value, such as services and machine engineering. Due to the limited labor supply, economic growth will barely exceed 1% without increases in productivity. Only a combination of factors will increase TFP: the expansion of investment activity, better quality of government services, economic policy and a strong corporate governance system.

A better investment climate is also influenced by the quality of the government's economic policy. Several positive changes occurred following the 1998 crisis, primarily in macroeconomic policy. The 1998 default and devaluation helped eliminate macro distortions in the economy. The debt crisis was a result of running a chronic fiscal deficit, along with inconsistencies in monetary and

fiscal policies. Today, the floating exchange rate of the ruble and a fiscal surplus diminish any threat of a new crisis.

Economic distortions are not only caused by weak macroeconomic policy, however, but also by the absence of a sound regulatory and legislative environment, undeveloped market institutions and poor corporate governance. Although Russia has reported progress in recent years, successes in structural reforms and the advancement of market institutions are less visible. Consistently high oil prices have made macroeconomic policy a much easier matter, allowing the government to secure macroeconomic stability and build up reserves by tapping into sustainable foreign exchange inflows.

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As a result, Russian companies were not motivated to improve their corporate governance. This has changed in the past two years.

Financing Fixed Assets

Russian executives clearly understand that they are competing with imports and foreign producers in new market segments. They know that modernization and technological advancements will play a decisive role in their ability to be competitive and produce goods both for the domestic market and export.

Investments in fixed assets are becoming a catalyst for economic growth. Russian companies have a growing need to attract loan proceeds to finance investment. For their part, Russian and foreign investors alike are looking first at the quality of corporate governance in prospective companies and also progress in the legislative and regulatory institutions of the country. For these reasons, both government and business are highly aware of the need to improve corporate transparency as an integral element of sound corporate governance, as can be seen from the latest surveys.

About two-thirds of Russian companies intend to enter the capital markets in the next 12-18 months. This figure is below the number of companies that believe they need to make significant improvements in corporate governance. About 78% of the companies intend to make

improvements in their corporate governance on their own initiative. Fully, 90% of companies will improve corporate governance if regulators toughen requirements.

Doubling GDP cannot be achieved within existing market structures. Obsolete equipment, underdeveloped market institutions, and a sluggish economy will only continue to stimulate the current export-oriented economy, leading to a further exodus of skilled labor from Russia to the competitive global labor market.

Wage Growth Is Key Economic Driver

Sustainable high growth rates could be achieved through modernizing the economy and increasing efficiency, thereby addressing the urgent problem of increasing household incomes. Wages are an extremely important economic factor, not just a social issue. The current low wage level hampers the development and modernization of industrial companies. The cheap workforce, if it continues, encourages the expansion of outdated plants and the ability to train an increasingly skilled labor force. Wage growth and career growth should be viewed as a catalyst to increased efficiency of Russian companies and as a key to maintaining vitality in the national labor market.

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Importance of Diversifying the Russian Economy

Many positive changes became visible in 2003. Industrial output increased by 7%, and employment dropped by almost 6%. Higher costs caused by higher heat, energy and freight tariffs forced companies to cut other costs. Excessive workforce sizes – a legacy of the old administrative system – was the first area to be affected. Industry restructuring was also encouraged by the expectations for appreciation of the ruble. Structural changes within companies allowed for increased productivity and competitiveness of national producers.

To sustain high growth rates, it is critical to encourage investment beyond the resource sector to processing industries and other high value added sectors. The government must design sound incentives to reinvest profits from the energy sector elsewhere within the national economy.

In contrast to other transition economies, Russia's extractive resources for exports generate a large trade balance surplus that can act as its own internal source of financing for development. Unless industrialized, resource owners prefer to invest in the expansion of their core businesses (which might generate the symptoms of the "Dutch disease") or in foreign assets as a means of diversification. Either way, the result is an over-concentration of wealth in the extractive resource sector holding companies.

Lowering administrative barriers that hamper diversification, growing the economy, and building a well-performing private financial system will change this dynamic, attract investment to new sectors, and meet the demand from rapidly growing sectors for debt financing.

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Building a financial intermediation system to re-allocate resources should be a priority. Development of an insurance system and a vibrant securities market will also encourage investment growth. Furthermore, bankruptcies by weak companies, development of competitive companies through financial restructuring, and a small and medium-sized enterprises (SME) - friendly environment will all help create a healthy investment environment.

I.3.

TRANSITIONING TO A NEW GROWTH MODEL

Despite high post-crisis growth rates, Russia's level of economic development remains rather low. Per capita GDP is slightly above \$7,000, in purchasing power parity, and about \$3,000 at the current exchange rate. These levels are several times below those of many emerging markets, let alone those of developed economies. This results in a poor quality of life for Russian citizens, a situation that is further aggravated by a vast income disparity among economic levels.

The situation has improved over the past two years in part due to some of the government's economic measures, including reforming taxation and making public expenditures more efficient. The tax, budget and

land codes have been adopted and the Duma passed laws on pension and electricity sector reform, and to lower administrative barriers for small businesses.

Still, the government's actions do not always meet expectations. Many of the scheduled reforms have not been executed, particularly the reform of natural monopolies. The government has not curbed the growth of fiscal expenditures, substantially reduced the magnitude of corruption (the corruption index in Russia, as measured by Transparency International, did not change over the past few years), nor achieved sizable progress in reforming the financial system. It is important to note that the government only started administrative reform in the second half of 2003.

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Positive trends in the economy are largely due to growth of large- and medium-sized companies. Capital flow statistics illustrate this. Capital outflows declined significantly in 2003, while Russian corporations' external borrowing increased. This is a direct result of the strengthening of large Russian businesses, their improved transparency and governance. Borrowers moved to international accounting standards, disclosed their shareholders, and took sound measures to improve corporate governance.

Sustaining Growth Requires Social and Economic Change

Sustaining growth at high levels, however, requires more vigorous social and economic transformations. The experience of Latin American countries in the last two decades showed that growth could be slowed, stagnate or decline if structural and institutional reforms are not completed. A favorable external environment could support growth in Russia in the coming years. Growth will inevitably decelerate, however, if oil prices decline. The main challenge for the period immediately ahead is to complete institutional and structural reforms. Top priorities include improvements in corporate governance and expansion of companies that follow international governance standards.

The government's strategies include:

- Incentivize a substantial increase of non-resource exports, higher domestic demand and diversification of the economy
- Re-channel capital from the natural resource sector to processing industries
- Encourage foreign direct investment (FDI) in new technologies and those industries that will help reduce imports
- Grow new industrial sectors, build stronger competitiveness and nurture small businesses. All these measures could lay the groundwork for a rapidly growing Russian economy. SME could help raise labor productivity and generate a middle class which has high solvable demand.

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These strategies are intended to reduce the energy-to-output ratio in the Russian economy.

Favorable conditions must also be created for starting and expanding a business. High administrative costs remain a major obstacle for the development of new sectors and small business. Reforms in this area have not yet been completed and would spur capital outflows and curb foreign investment inflows.

Action Required by the Government

In summary, several areas must be addressed by the government.

First, the main obstacle to improving the investment environment in Russia remains the high and burdensome level of state intervention in the economy. Examples include the government's broad authority to reallocate economic resources, high administrative barriers for business and excessive taxation.

Second, the existing institutional, financial, and informational infrastructure does not meet the needs of business and leads to excessive transaction costs.

Third, Russia's economy limits the benefit of foreign trade due to excessive customs and foreign exchange regulation. The new law on foreign exchange control, passed in late 2003, has yet to resolve the majority of problems.

Fourth, government support is spread across all sectors, curbing diversification of the economy. Unequal conditions for competition are also obstacles to diversification.

New stimulus to Russian economic growth will result from the following reforms:

- Strengthen the judicial system and rule of law in guaranteeing lawful business practices
- Reduce the role of government in the investment process
- Focus government support on stimulating growth in the “new” sectors of the economy
- Enhance the openness and accessibility of information about the Russian economy and government executive decision-making
- Implement legislative and regulatory measures to encourage companies to embrace international accounting standards
- Build a social services, training and administrative system to develop the skills, knowledge and abilities of the Russian workforce.

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These reforms will lower the risks of investing in the Russian economy and make investing equally attractive for domestic and foreign investors. It is crucial that socially oriented reforms (housing, utilities, education, and health care) are implemented as they will have a lasting effect on the economy. Reducing the required term of military service and building a professional army will also have a positive impact on Russia’s domestic economy.

**I.4.
CORPORATE GOVERNANCE
AND INVESTMENT
IN THE RUSSIAN ECONOMY**

The Russian economy became more attractive for investment in 2003 with two leading rating agencies raising Russia’s sovereign rating. Non-financial and financial companies alike actively borrowed on world markets, attracted by relatively low interest rates and the

appreciation of the ruble, particularly its robust strengthening against the dollar. Capital outflows also declined significantly, and the Russian stock market grew rapidly with an inflow of foreign investment.

Diversification of Russian exports is an important priority. Russia's dependence on the export of natural resources is rooted in the Soviet economy that faced major problems when world prices of natural resources dropped. In particular, plummeting oil prices in the second half of the 1980s forced the Soviet government to borrow on world markets to finance needed industrial and consumer imports.

The share of export in Russia's GDP is rather large (about 30%). At the same time, foreign direct investment in GDP does not exceed 1%. Russia also trails most transition economies in per capita foreign direct investment (FDI). Most economies in transition report large foreign capital investment that boosts per capita income as well as consumer imports. This helps diversify their economy, promote industrial technologies and train business leaders. As a consequence, Eastern European economies managed to re-direct a large share of their exports from East to West and integrate into the European economy.

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In recent decades, Asian countries had a similar experience. Foreign direct investments brought about major changes in their industry structures, rapid export growth and an economic rebound.

Low Foreign Investment in Russia

Foreign investments do not play any significant role in the Russian economy. A large share of FDI goes into the oil sector, which does not help diversify exports. Key FDI segments are the food industry, trade and financial sector, and other domestically oriented industries. The average annual FDI inflow in Russia in recent years has been approximately \$3 billion, which clearly is insufficient to effect real change in the economy.

The relatively low level of direct investment is because strategic investors are cautious about:

- Accessibility and transparency of information on business operations and government decisions

- Credible financial reporting
- Reliable control by oversight authorities
- Guarantees of investor rights and stable relations between business partners.

Non-resource export levels scarcely changed in the past seven to eight years, ranging between \$40 billion and \$45 billion a year. Total exports depended on fluctuations of energy prices and changes in the volume of exported oil and petroleum products. The share of natural resources (particularly oil and gas) in exports increased, indicating a change in the structure of Russia's export. Non-resource export proceeds increased after the 1998 crisis but not enough to change the overall picture. Fuels, metals, wood, pulp and chemicals take up approximately 85% of Russian exports. Given the small share of machine engineering and other manufacturing in Russian exports, changes in exchange rates do not have any significant effect on the volume of exports. Exports are much more affected by the fluctuations of prices of metals and fuels.

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The largest share of export proceeds in the oil, ferrous and non-ferrous sectors comes from a few well-known companies traded on the Russian and foreign stock markets (YUKOS, LUKOIL, Sibneft, TNK, Surgutneftegaz, Severstal, Norilsk Nickel, SUAL). It is these companies that compose the bedrock of Russia's stock market, and many of them have a higher level of corporate governance than most Russian corporations. One could say that global economics promotes not only industrial growth but also better corporate governance.

Most companies with good corporate governance either have foreign invested capital or actively borrow on the global capital markets. It is not just financial resources that are important but the transfer of business culture to the national market.

Russian Business Views of Corporate Governance

Recent surveys show that most companies are not satisfied with the quality of their corporate governance. Corporate scandals in the U.S. stimulated comparisons of corporate governance in Russia versus that in the U.S.

In one survey, only 1% of Russian companies believe that corporate governance in Russia is better than in the U.S., 4% say the levels are the same, and 62% said Russian companies have a much lower level (the remaining 33% could not answer).

The companies were critical not only of the average level of corporate governance in Russia but about their own boards as well. Half of the surveyed companies said their situation is worse than the general situation countrywide. About 25% say their corporate governance is better than the country average. Most companies believe their corporate governance improved after they enacted the Code of Corporate Conduct.

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The quality of corporate governance differs across companies, but also across industry sectors. Significant progress was reported in the past two years in the communications sector. Based on 2002 performance, VimpelCom and MTS were put in the top 10 telecom companies worldwide most attractive to investors, and the 2003 performance placed MTS as one of the five most attractive companies in the telecom sector. The value of Russian telecom companies in 2002-2003 was 20-30% above the value of similar Central and East European (CEE) companies.

I.5. ROLE OF FINANCIAL SECTOR IN SUSTAINABLE GROWTH

In addition to the expanded presence of foreign capital in the Russian economy, growth will require a broadened domestic financial system, particularly in banking and the securities market. The need to finance growth will result in greater openness of companies and, therefore, better corporate governance. As noted earlier, integration of Russia in the global economy will also have a positive impact because improved transparency of cash flows is a *conditio sine qua non* in this integration.

Ownership structure is also important in terms of a company's motivation to improve corporate governance. Such factors as appropriate legislation, FCSM standards

and the position of shareholders are the driving forces in companies' corporate governance policies.

Monetization and the Russian Economy

In addition to corporate governance problems that constrain capital inflows, certain fundamental factors are particularly important in evaluating the long-term prospects of Russia's economy, financial markets and entire financial system.

Monetization of the Russian economy is still low. Although M2/GDP increased from 14% in 1999 to 25% in 2003, this figure is still below most other emerging markets. Monetization, however, cannot be pushed up quickly or artificially. It increases as the economy grows, and per capita income and profits go up as confidence strengthens and incentives for savings appear.

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Monetization will continue to increase with economic gains, provided there is progress in reforms. The money supply can be expected to go up at a faster pace than GDP. Russian stocks should grow more quickly than GDP, provided that this growth correlates with money supply dynamics. This is exactly what happened in past years. The market and financial system should continue to report high growth rates in the long term, although this does not preclude short-term fluctuations in any given period.

Russia's Domestic Financial Sector

As growth continues and incomes increase, so will savings and consumer spending. Demand for financial services, including insurance, investment funds and banking services, will develop at an increased pace. Establishing clear rights to private property will promote the growth of mortgage lending.

Low monetization of the Russian economy, coupled with the fragmented banking system (there are still more than 1,300 banks in Russia), create certain restrictions in obtaining loans. On the one hand, low monetization means a high monetary volatility, and one cannot expect long-term loans in this context. Bank credits will have longer maturities as monetization goes up.

Small banking institutions account for the largest share of the Russian banking system. Most are unable to service large and rapidly growing companies that need significant, long-term credits. On the other hand, the growth in lending to the non-financial sector looks appropriate. As companies turn to the external market for credit, they will have to improve their corporate governance to negotiate better terms of credit.

Similar trends can be seen in smaller companies not yet ready to approach external lenders. Unable to receive long-term credit from one source, they issue more ruble-denominated debt obligations. Thus, they borrow from many creditors, not one. As they enter the domestic capital market, they improve their corporate governance, too, in order to place bonds more profitably.

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Long-term fundamental risks in Russia may well be lower than in many other emerging markets. Unlike these countries, Russia is expected to maintain a strong current account in the few years ahead, mostly because of the structure of its economy. The floating exchange rate and current macroeconomic policy will help prevent any new crisis. Even in the case of a lasting decline of oil prices, any devaluation of the ruble will be gradual.

2 CORPORATE GOVERNANCE: RUSSIAN LEGISLATION AND COURT PRACTICE

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2.1. LEGISLATIVE AND JUDICIAL OBSTACLES TO THE DEVELOPMENT OF CORPORATE GOVERNANCE

A legal framework to develop the Russian stock market was put in place when federal laws On Joint-Stock Companies and On the Securities Market became effective in 1996. These laws had several limitations that became evident during privatization era and establishment of joint-stock companies. A particular shortcoming was the absence of a well-regulated equity market required to protect shareholders and to help enforce key legislative provisions.

The re-distribution of ownership in Russian companies has had a mixed impact. From a positive standpoint, it helped to transfer management control to owners who were more effective than earlier managers. In contrast, due to an immature legislative and judicial system, the re-division of property in many cases was unfair, affecting both effective and ineffective owners.

Past Abuses Damaged Russia's Investment Climate

Inadequate legislative and judicial systems resulted in the following:

- Ownership interests of some shareholders increased at the expense of other shareholders or third parties without proper compensation (dilution of the shareholder capital)
- Some shareholders were expelled from joint-stock companies against their will and without proper compensation (“squeezing out” of shareholders)
- Asset-stripping became a regular practice of entrenched owners
- Hostile takeovers took place without proper compensation to shareholders of target companies
- Shareholder registration abuses took place, especially related to ownership information
- There was manipulation of shareholder voting results at general meetings.

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Among the major problems affecting the development of Russian companies in the 1990s was the widespread practice of gaining control over joint-stock companies by removing shareholders and diluting their capital. These “dilution” and “squeezing-out” practices took many forms and often did not conflict with the law.

Most cases of “dilution” involved the placement of additional shares. The On Joint-Stock Companies law neither protected pre-emptive rights of shareholders nor defined procedures for establishing the market value of shares. This made it easier to transfer stakes at below market prices from some shareholders to others, or to persons closely affiliated with some shareholders and/or management. Dilution was usually carried out through a closed subscription to additional shares. Nevertheless, so-called open subscriptions that permitted all shareholders to participate also could be manipulated -- and turned, in effect, into a closed subscription -- by requiring that “unique” property, which only one owner held, must be used as payment for shares.

The earlier version of the law On Joint-Stock Companies made it possible to increase a joint-stock company's authorized capital by placing additional shares only among its majority shareholders. Other shareholders'

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stakes were reduced in size as a result. Selling company shares held in its treasury created dilution.

Reorganization procedures included in the law presented broad opportunities for squeezing out some shareholders. Cases were frequent whether shareholders found themselves in well-financed companies or debt-ridden ones that emerged after splitting up former joint-stock companies. In reorganizing, the law permitted termination of shareholders' participation by converting their shares into other securities (such as bills or bonds).

The practice of consolidation also was used frequently. In this process, thousands of shares were consolidated into a smaller number of shares, and only a few shareholders retained their full stake in the company. A similar practice took place in the establishment of holding companies, when unfair ratios were used in exchanging subsidiary shares for holding company shares.

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Asset stripping was another problem, as there were no clear procedures relating to shareholder approval when a company conducted a significant transaction or restructured financially. Shareholders regularly would be harassed and had no legal recourse to prosecute their cases against managers.

The legislation also lacked clear requirements for managing general meetings of shareholders. This led to managers or controlling shareholders manipulating results at general meetings to their own advantage. Moreover, meetings of shareholders were held in locations that were inaccessible, and without proper notification. In some cases, shareholders were not even admitted to the general meetings or, when they arrived, were told that the meetings were concluded.

The law did not set explicit requirements for dividend payments, and some shareholders did not receive dividends until long after they were scheduled to be paid. The law did require joint-stock companies to pay compensation to the shareholders who lost their shares, but often only token amounts were paid and did not correspond to the actual value of shares.

Illicit acts became common. For example, shareholder registers often would be changed, resulting in the

loss of shares by some shareholders. Companies would claim that documents had been lost, either through theft or in a fire. Often, the “recovered” register differed greatly from the original. The most egregious offenses occurred where issuers or their affiliates kept the registers. The most common technique was falsely to claim insolvency, and then buy back shares at greatly reduced prices.

The Judicial System Failed to Protect Investors

In the 1990s, the judiciary system also demonstrated that it could not protect shareholder interests. Poor legislation was exacerbated by court rulings that, in some cases, were illegal. In cases where a joint-stock company was the defendant, shares in the company would be confiscated. Seizure of shares before a shareholders meeting was common. Unfounded suits would be filed and annulled after the meeting. Courts had the authority to ban participation of shareholders in a meeting, nominate candidates and take positions on a joint-stock company’s management or governance body.

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The absence of meaningful criminal penalties resulted in weak protection mechanisms. Until 1996, criminal law did not include criminal corpus delicti related to the performance of management. Shareholders received new and stronger protection of their rights before 1999 with the passage of the federal law On the Protection of Rights and Legal Interests of Investors on the Securities Market. This law specified what was deemed to be legal and illegal activities of companies listed on the securities market.

The widespread scandals, along with the poor protection of investors, adversely affected the investment climate in Russia. Foreign investors have played an important role in changing this environment by urging the acceptance of generally accepted principles of corporate governance.

Federal Laws Begin to Change the Rules

The first steps toward providing a legislative solution to the “dilution” problem were taken in late 1990s. The federal law, On the Protection of Rights and Legal Interests of Investors on the Securities Market, included a

requirement to hold closed subscriptions only after a two-thirds majority vote at the general shareholders meeting. The law stated that shareholders have the right to pay money for shares, thus preventing an open subscription from turning into a closed one by paying for shares with “unique” property. These provisions were to be in force until appropriate rules are incorporated in the federal law On Joint-Stock Companies. The process on amending the bankruptcy law began concurrently.

Emphasis was placed on corporate governance in the regulation of joint-stock companies after 2000. This resulted in the passage of amendments to the federal law On Joint-Stock Companies and in the drafting of the Code of Corporate Conduct by the Federal Service on Financial Markets (FSFM – formerly the FCSM). These documents have fundamentally changed the investing environment.

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LEGISLATIVE PRINCIPLES IN PROTECTING SHAREHOLDER RIGHTS

Ownership rights are dependent upon well-organized title records, and this practice has become much more reliable in recent years. This is a result of (i) tightened standards prohibiting issuers themselves from maintaining equity registers; and (ii) the FCSM's efforts to license and supervise registrars, which helped to weaken dependence on the issuers. Today, securities ownership in Russia is recorded by registrars and depositories that are licensed and overseen by the FSFM (and before the FCSM). In cases where shareholders do not exceed 50 (500 before 2002), the register may be kept by the joint-stock company itself.

Russian legislation requires free circulation of shares issued by the open joint-stock companies. Under current law, shareholders of closed joint-stock companies have the pre-emptive right to buy shares if they are sold to third parties. The 2002 revision of the law removed a provision whereby joint-stock companies' by-laws could include consent for assigning shares to third parties.

Today, only a vote by shareholders (or by the board of directors if the by-laws allow) can authorize the

placement of additional shares. Under law, a company can conduct a closed subscription, or place more than 25% of its shares through an open subscription, only with a majority vote at a general meeting of shareholders (three-quarters of the shareholders must be present at the meeting). At the same time, the law requires that shareholders have the pre-emptive right to buy additional shares. In the case of a closed subscription, this right is given to shareholders that voted against it or did not take part in the general meeting where this decision was taken. Shareholders have the right to buy additional shares for cash even if the placement terms state that non-cash instruments can be used for payment. The law requires that the additional shares must be offered to all shareholders to prevent dilution of their capital.

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The law also protects the rights of dissident shareholders during reorganization. It includes a ban on the conversion of shares into other securities during reorganization. In cases of spin-offs and divestitures, shareholders who voted against reorganization or did not vote must receive shares in all joint-stock companies that are established as a result. The number of these shares must be prorated to the number of shares held by the reorganized company's shareholders. The new shares must carry the same rights as the old shares. In addition, the law states that these shareholders have the alternate right to "put" their shares to the company. Fractional shares resulting from consolidation give the same rights as whole ones and can be traded in the same way. Thus, the law prevents the use of consolidation to squeeze-out shareholders. These requirements, effective since 2002, broadly solved the problems of dilution and squeeze-out.

The Law On Joint-Stock Companies Lays Groundwork for Corporate Governance

The law On Joint-Stock Companies vests the general meeting of shareholders with the authority to take the most important decisions related to the company. These include amending its by-laws, reorganization, liquidation, executing large transactions (an amount over 50% of the company's balance sheet) and related party transactions

over 2% of the balance sheet. Decisions related to amending by-laws, reorganization, liquidation and certain other decisions require approval by three-fourths of shareholders at the general meeting.

Under this law, the general meeting's decisions are representative because a quorum must exceed one-half of all outstanding shares (and 30% in the case of a reconvened meeting, if the preceding one did not have a quorum). The law permits a smaller quorum for the reconvened meeting only for joint-stock companies with more than 500,000 shareholders.

Only shareholders who own ordinary shares usually take part in the general meeting. Yet, in some cases, the law permits inviting owners of preferred shares to the meeting, and authorizes them to vote. Such cases involve voting on reorganization and liquidation, and restricting the rights of privileged shares. Since 2002, a decision to restrict preferred share rights requires the approval of three-quarters of votes on the appropriate preferred shares. Shareholders who own preferred shares for which a dividend has been announced may take part in the general meeting and vote on all agenda issues in the case of non-payment of dividend in full.

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The law also requires that shareholders be notified 20 days before the general meeting (30 days before a meeting if its agenda includes reorganization issues). Shareholders have the right to read in advance materials necessary for decision-making and drafts of proposals. The law also sets out the procedure for presenting such materials. Under law, voting is based on the principle “one share, one vote.”

The On Joint-Stock Companies legislation permits absentee voting for shareholders at all general meetings. This means that shareholders may send in their votes on agenda issues but may be absent from the meeting itself. If the general meeting is held in praesentia, shareholders may attend it in person. A general meeting must be held in praesentia, if it is to elect the board of directors or audit committee, approve the auditor or discuss issues outlined by sub-paragraph II. The law requires that shareholders must be informed

about the general meeting's decisions no later than 10 days after the vote.

Since 2002, the FCSM has been authorized to set additional requirements for convening and holding a general meeting. One FCSM regulation states that a general meeting of shareholders must be held at a company's headquarters, unless an alternative site is allowed by the company's by-laws or any document approved by its shareholders. The FCSM requirements regulate the schedules for sending notices about the general meeting, items for the agenda, ballots, registering of meeting attendees and other procedural issues.

The law On Joint-Stock Companies, as amended in 2002, shortens the deadline to six months for shareholder suits that challenge a decision taken by the general meeting. By limiting this period, the legislature sought to eliminate the possibility of challenges long after the event. The attempt was not completely successful because by the courts' approach the period of challenging begins on the day when the person whose rights may have been impinged learned of it or should have learned of it. In 2003, the Supreme Arbitration Court changed this rule. Specifically, it stated that the limitation period could be restarted if an individual has failed to file a reasonable challenge in the prescribed period.

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Radical changes also occurred in court practices. For instance, the Supreme Court (October 2001), followed by the Supreme Arbitration Court (July 2003), spoke against the courts' and servers' abuse of seizures and bans imposed in the process of executing court rulings. The supreme judicial authorities stated that measures taken by the courts should not paralyze the work of companies or unreasonably restrict execution of rights embodied in shares.

The law sets a 60-day period for paying dividends and invalidates an earlier unclear provision about the payment period. In November 2003, the Supreme Arbitration Court ruled that shareholders may claim interest for delayed payment of dividends announced by the company.

The law On Joint-Stock Companies also specifies that large transactions may be made only if approved by:

- The board of directors, in transactions from 25% to 50% of balance sheet value, or
- The general meeting of shareholders, in transactions exceeding 50% of the balance sheet.

Board decisions to approve such transactions must be unanimous, and the general meeting must approve them by a majority (three-fourths of the votes). The law also extends these rules to loans, credits, pledges and warranties. The rules did not apply to these other categories before 2002, allowing courts to exempt them from large transaction rules. The approval of a large transaction can no longer be considered a general approval of other similar transactions. The terms and partners of each transaction must be approved separately.

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The law also specifies procedures for related-party transactions. These include transactions with direct or indirect participation of a board member, CEO, member of management or a large shareholder (owning or controlling 20% of more of the company's voting shares). In 2002, the law was revised to include anyone authorized to issue directions that are binding for the company. The law also requires that a related-party transaction must be approved before it is executed. As in the case of a large transaction, the partner, terms and conditions must be clearly stated when such a decision is made.

There also was progress relating to judicial procedures for large and related-party transactions. In particular, court rulings were issued that help define the criteria of "relatedness" in transactions.

... *But More Must Be Done*

Despite these substantive improvements in the legislative framework and judicial practices, some problems remain. Regulation of ownership record keeping, as well as insufficient enforcement authority vested in FCSM, is limiting public information about the real owners of joint-stock companies.

An illiquid securities market is an obstacle to determining the fair market value of company shares. This is particularly important in the case of a company

buying out shares of an individual investor, and makes investor protections difficult in relation to such issues.

As currently addressed in Russian legislation, takeover procedures require more explicit language. The legislation does not provide for equal treatment of all shareholders, nor does it guarantee their right in all cases to sell shares at a price equal to all other shareholders.

Another problem is the current system of administrative fines, which is described in the law On the Protection of Rights and Legal Interests of Investors on the Securities Market and the new Code of Administrative Offense. These laws are ineffective in imposing administrative fines, and, when implemented, impose very small fines (the largest amount is under \$2,000). As a result, there is only token punishment for violations in managing or governing joint-stock companies, breaching the rules of register keeping or the use of official information.

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Furthermore, the new Code of Arbitration Procedures passed in 2002 failed to provide full separation of jurisdictions for the Supreme Arbitration Court and the Supreme Court with respect to disputes related to joint-stock companies. As a result, these two judiciary authorities still take different and sometimes contradictory approaches to settling the same type of disputes.

2.3.

REGULATION

OF CORPORATE GOVERNANCE PRACTICES

The law On Joint-Stock Companies specifies a single-person executive (the CEO) and the possibility of a collective executive body (the management board). Their authority covers all issues that are not the mandate of the general meeting of shareholders and the board of directors. Executive bodies are established by the general meeting of shareholders or the board of directors, if the by-laws authorize the latter to do so.

The law requires that joint-stock companies with more than 50 shareholders must have a board of directors mandated to handle issues of general governance (except

issues that the law treats as the authority of the general meeting) and oversee executive bodies. Pursuant to this law, the board of directors approves elements and priorities of the company's strategic plan. The by-laws can expand the board's mandate to include issues that otherwise are the purview of the general meeting, including:

- Important operational issues (reorganization, liquidation, participation in financial-industrial groups)
- Borrowing an amount representing more than 25% of capitalization
- Profit distribution
- Large transactions (up to 50% of the balance sheet)
- Related-party transactions.

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The Russian joint-stock company model has an important feature: a ban on extending the general meeting's authority beyond the limits stated in the law. This makes the board of directors an extremely important body as, pursuant to the federal law On Joint-Stock Companies, the board of directors must be formed by the general meeting of shareholders. In joint-stock companies with more than 1,000 shareholders, the board must be elected by cumulative voting and include at least seven members. Cumulative voting means that the number of members standing for election to the board may multiply eligible votes. The shareholder may then cast all these votes for one nominee or distribute them among several nominees. Candidates with the largest number of votes are elected through this procedure. Cumulative voting is beneficial to minority shareholders in electing their candidates to the board (by counter-balancing majority votes) and influencing future board decisions. In February 2004, the Federal Assembly amended the law On Joint-Stock Companies to require election of boards of directors by cumulative voting regardless of the number of shareholders. These amendments are an important step toward better corporate governance in Russia.

Code of Corporate Conduct Extends Guidelines for Governance

Since 2002, the law has attempted to restrict management influence by limiting it to no more than one-fourth of the

seats on the board. The earlier law allowed management up to half the seats. Even more important are recommendations in the Code of Corporate Conduct, which proposes that at least one quarter of board members should be independent. According to the Code, independent directors are persons who are not members of management, are independent of the company's executives, their affiliates and its large partners, do not have other relations with the company that might affect their independent judgments (e.g., they do not receive more than 10% of their income from the company), and are not representatives of the government.

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The law sets the requirement for a quorum at board meetings (at least one-half the board must be present) and prescribes that board members exercise their authority in person. In addition, the Code of Corporate Conduct recommends establishing several board committees that study in advance the most important issues facing the board and draft recommendations for appropriate decisions. The Code recommends establishing the following committees:

- Strategic Planning Committee – to define the company's strategic goals and its development priorities, and to evaluate the effectiveness of the company's long-term performance
- Audit Committee – to oversee the company's financial and business plan, to draft recommendations on independent auditors, and to communicate with this auditor and the company's internal audit staff
- Personnel and Compensation Committee – to define the selection criteria for board candidates, CEO, and members of management; draft their contractual terms and conditions, evaluate candidates and management performance; and to establish executive compensation policy
- Corporate Conflicts Committee – to prevent, and effectively resolve, corporate conflicts among the company's shareholders.

Russian legislation requires executives to act reasonably and in good faith in the interests of the company. Thus, they are obligated to act in the interests

of all shareholders, not only those who nominate and support them. In turn, the Code of Corporate Conduct interprets this requirement as every executive's obligation to be careful and prudent, as could be expected of any responsible executive in a similar situation under similar circumstances. The law On Joint-Stock Companies and the new Labor Code, which became effective in 2002, state that the authority of management and the board of directors may be terminated at any time by a shareholders vote. Management accountability remains the main problem. Courts are still not ready to apply the principles of reasonableness and good faith when judging managers' actions. Disputes about the limits of management responsibility and the grounds for their dismissal have not been resolved. In order to solve these problems, more explicit language in labor legislation and the Code of Corporate Conduct is required.

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Russian legislation has strengthened management accountability. Amendments to the Civil Code, made in 2002, include new types of criminal *corpus delicti* related to management, such as negligence in disclosure of information, abuse of authority and commercial bribery. This strengthening allowed for criminal prosecution of corporate governance offences; however, only a few actual cases have been tried, despite the fact that many cases have been made public.

2.4. LEGISLATION AND THE DISCLOSURE OF INFORMATION BY JOINT-STOCK COMPANIES

Russian legislation establishes the disclosure of information as the key element of corporate governance and that shareholders have the right to receive timely information. Shareholder and investor confidence is based on having equal access to information regarding a company's financial situation, transactions that might change its performance and the structure of ownership. Such appropriate disclosures help shareholders make informed decisions, and reduce the possibility of insider trading.

Russian rules for disclosing both financial and non-financial information by joint-stock companies are currently consistent with the requirements of the European Union and International Organization of Securities Commissions. All Russian companies will make the transition to international accounting standards (IAS) in the next few years. Starting in 2004, this reporting will be standard for lending organizations and issuers to be listed on stock exchanges. Issuers that are already listed on the stock exchanges will move to IAS by 2005.

FSFM Strengthens Rules on Disclosure and New Issues

Joint-stock companies that expect to make public placements must prepare a prospectus and register it in the FSFM (banks must register with the CBR). The prospectus must include:

- Company's financial situation, including the results of its financial and business performance, risk factors and other financial information for the past three years
- Structure of the company's management and governance bodies, with details about their members
- Capital structure of the company, including identity of owners with at least 5% of ordinary shares and their related-party transactions in previous years
- Details of the procedure, terms and conditions of placement of qualified securities.

The FSFM prescribes in detail the nature of information to be disclosed in the prospectus. In accordance with the Russian legislation the prospectus must be approved by the board of directors, and its information must be confirmed by the chief executive officer, chief financial officer, auditor, appraiser and financial consultant (such as investment banker).

The reliability of the information in the prospectus is guaranteed by the property of those who sign and approve it. Members of the board, as well as those who sign the prospectus, are subject to criminal prosecution for presenting misinformation if it damages citizens, organizations or the government.

Companies must issue quarterly financial reports to their shareholders no more than 45 days after the close

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of each reporting period. This report includes the same information as the prospectus, except that it reports on performance in the most recent quarter (and cumulatively for the year in question). Companies and their managements are liable for delays in issuing quarterly reports.

The law requires disclosure of information about issuers, including substantive changes in the company's financial situation, changes in the structure of its management or governance, legal status, and other information that might affect the value of securities.

2003 Amendments Address Additional Procedures

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The 2003 amendments to the law outlined procedures and timelines for disclosure. For example, public companies must have a website that discloses information about the company, including its by-laws, internal documents detailing the work of corporate governance bodies, the prospectus, quarterly reports, information about affiliates, and other material facts.

Companies are also required to disclose information on a newswire authorized by the FSFM. Companies must also publish information in a printed periodical. Information must be disclosed on the newswire one day after the decision or event subject to disclosure. The timeline is three days for disclosure on the website; five days for disclosure in a printed periodical. Regulations specify the shortest possible timelines for disclosure of material facts, with a view to reducing the possibility of insider trading. Special rules are set for companies traded on stock exchanges. Any information that might strongly affect the value of listed securities must be shared with the exchange before it is disclosed on the newswire.

Stronger Rules Needed on Shareholder Disclosure and Insider Trading

Although disclosure requirements were strengthened substantially, some problems remain. One of the most important is the disclosure of the company's shareholders. In fact, a company might only learn about ownership changes while preparing for the general meeting. This

lack of knowledge can result in failure to provide regular disclosures to the company's shareholder base.

The law On the Securities Market does not resolve this problem. The law requires that information be sent to the FSFM about the purchase of more than 20% of any issuer's securities and about changing this stake by 5%. Since non-compliance entails no penalties, however, the FCSM rarely received such information. If it does, the law does not require or authorize a regulatory body disclose this information to the market.

Nor can information about beneficiary owners of securities be obtained. Shareholders often hide their stakes by buying shares through one or more offshore companies that have no formal identification with the beneficiary.

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The use of insider information is an acute problem. The law On the Securities Market includes the concept of "restricted information" and a ban on using it. The law, however, has the following faults:

- The definition of "restricted information" is not clear and does not fully describe all aspects of insider information
- Most people who have insider information are not banned from using it and sharing it with third parties. In particular, the law does not treat professional investors, board members, issuers, appraisers and auditors as insiders
- Legislation does not ban using insider information when making transactions for other parties, making recommendations or urging third parties to make transactions.

Russia does not prosecute instances of using restricted information. Both the law and enforcement are inadequate to protect the public from the damage that can be caused by such trading.

2.5. THE ROLE OF STAKEHOLDERS AND LOCAL AUTHORITIES IN MANAGING JOINT-STOCK COMPANIES

In line with the practice established in the 1990s, only shareholders, executives and officers were thought to be

responsible for corporate governance. This meant that the interests of municipalities and Federation member territories were ignored. Local authorities have strong influence on companies located in their jurisdictions, and this translates into a sizable social burden on such companies. Company policies are strongly affected by the interests of their employees, particularly early in the transition to a market economy. Executives, especially those who retained their positions after privatization, tended to ignore the interests of shareholders in favor of employees.

Many companies have failed to balance the interests of shareholders, managers and other stakeholders. The company's social role – the result of a compromise between management and government authorities – can often conflict with the interests of shareholders.

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The nature of relations with employees also needs to be revised. In the companies where many shareholders are employees, managers can act in the interests of employees at the expense of those shareholders who are not employees. This is most clearly seen in what are called “people’s enterprises,” or joint-stock companies of employees. A 1998 law eliminated the possibility of reaching an appropriate balance of interests in such companies. Shareholding employees value their jobs and are dependent on management. “People’s enterprises” are not true joint-stock companies because board directors ultimately are given unlimited authority and become irremovable.

The Code of Corporate Conduct recommends that management and board members heed the interests of all stakeholders – employees, the company’s partners, the federal and local governments. The Code proceeds from an assumption that all stakeholders have their own interests. With this in mind, reaching a balance of all stakeholders’ interests is essential for the company’s best, sustainable performance.

3 CORPORATE GOVERNANCE PRACTICES IN RUSSIAN COMPANIES

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3.1. FACTORS IN CORPORATE GOVERNANCE IN RUSSIAN COMPANIES

A growing number of Russian companies have begun moving from their previous short-term strategies, designed to strengthen ownership and control, to a longer-term strategy of managing for sustainable growth.

In the past, businesses could grow by buying assets cheaply. With privatization and increased consolidation in many sectors, however, these opportunities have diminished significantly. As a result, companies are refining their strategies, and in the process are becoming more competitive and making sound investments.

Natural resource companies – in oil, gas, and mining – have led this process. At the small number of Russian companies that have been listed among the world's top 500 companies since the 1990s, management and boards of directors have come to understand that business expansion requires access to significant resources -- and they are seeking new investors, both domestic and foreign. They also are listing on Russian and international stock markets, with the goal of increasing their capitalization.

In early 2003, controlling shareholders of SUAL-Holding, the second-largest company in Russia, signed an agreement with Flemings, a British investment company, to create a larger industrial group. The new group will include SUAL's industrial assets in Russia and Kazakhstan and Fleming's assets in Mozambique and Cuba. Under this agreement, the new company will place 25% of its shares on a European stock exchange within two years after it is established.

In the spring of 2003, controlling shareholders of Tyumen Oil Company (TNK), the fourth-biggest Russian oil company, signed an agreement with British Petroleum to establish a parity-based joint company BP-TNK.

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From 1998 to 2001, the largest Russian business groups aggressively competed to acquire assets. Some groups evolved into investment funds that lend to companies or buy them with the goal of restructuring them, increasing their market value and eventually selling them to a new investor. These groups tend to invest in companies that have substantial market shares, lead their industry sectors and have profitable growth potential. Examples are investments that Interros made in energy engineering, gold mining and agriculture; Alfa Group in telecommunications; AFK Sistema in biotechnologies and electronics; and Basic Element's acquisition of Gorky Automobile Plant and Ingosstrakh insurance company.

These groups also helped to establish new businesses in Russia. They include MTS (majority shareholder: AFK Sistema) and Vimpelcom (one of the largest shareholders is Alfa Group), the leading Central and Eastern European telecommunications companies. From start-up, the growth of these companies followed the Western model, including issuing shares on international exchanges.

Today, some of the largest integrated business groups are separating ownership and management. The leaders of these groups are gradually distancing themselves from day-to-day operational management to focus on long-term strategic leadership. As such, they are relinquishing the title of CEO to become chairman of the board of directors.

Their focus now is on governance and general oversight of the company or group of companies.

Unique Influences on Corporate Governance in Russia

Nevertheless, this process is still evolving. Most large Russian owners are still very active in day-to-day management of their companies.

Although gradually changing, we can expect the high concentration of ownership in the largest Russian companies to continue in the intermediate term.

As a rule, owners try to retain control even when they sell some of their stake to outside investors. An October 2003 survey by Standard & Poor's showed that 30 out of 45 companies with the highest market capitalization had a controlling shareholder (owner of more than 50% of the voting shares) and 44 companies had very large shareholders. In reality, the actual ownership concentration level might be even higher due to the close affiliation of various owners.

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Since the 1998 crisis, some Russian companies that started as medium or even small private firms have achieved leading positions in their industries and listed on Russian and international stock markets. Wimm-Bill-Dann Foods, for instance, started with a single juice bottling line and annual returns of \$30,000 in 1992. Today, it has become the biggest Russian producer of juice and milk products, with revenues of approximately \$1 billion, and is listed on the New York Stock Exchange. Similar growth is expected to continue. Experts predict that total market share of Russia's 10 largest integrated business groups will decline by 1-2% a year as a result of the growth of mid-sized companies. Surveys by the Higher School of Economics, Institute of the Economies in Transition and the Bureau of Economic Analysis revealed one typical characteristic: mid-sized Russian companies with a workforce of fewer than 5,000 employees and highly concentrated ownership usually have greater profitability.

Consolidation of assets in parent companies registered in Russia is playing a large role. In the past, offshore firms have been the official owners of these assets. With consolidation, there is a single security with

clearly defined underlying assets. While this process affected only the largest companies in 1998-2000, it has now expanded to regional and “second echelon” companies with annual revenues of a few hundred million dollars. Examples include the Pipe Metallurgical Company, the Ural Mining and Metallurgical Company and Ilim Pulp Enterprise.

This is an important development as consolidation strongly improves corporate transparency for investors and the government. According to experts, a large percentage of Russian company payments made in 2003 to offshore companies were actually sent to companies with Russian ownership to diminish taxation.

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Compared with countries that have diversified ownership structures, such as in the U.S., a high ownership concentration in large and mid-sized Russian companies can change corporate governance priorities. In Russia, for instance, the priority of corporate governance is to improve minority shareholders’ rights, rather than to ensure oversight of management. In recent years, the focus has shifted to the relationship between controlling shareholders and minority shareholders, particularly those in subsidiaries.

The Constructive Influence of Foreign Investment

Foreign investors who value and invest in companies based on best practices can play a major role in helping improve corporate governance in Russia. A survey carried out by the Russian Institute of Directors (RID) in June-September 2003 showed a positive correlation between the level of corporate governance and share price on leading Russian exchanges. This finding, however, was limited primarily to a group of 10 to 12 “blue chip” companies. In most cases, domestic investors’ main criteria for investment are the company’s size and its market share. The Russian market and business community must encourage investors to pay closer attention to the role of corporate governance in valuing a company’s shares.

Approximately 20 to 25 companies have announced their objective to conduct an IPO within the next two years. This includes companies in the metallurgical sector

(Severstal, Mechel, Magnitogorsk Metallurgical Combine, VSMPO-Avisma, Ural Mining and Metallurgical Company); wood and woodworking (Ilim Pulp Enterprise); machine engineering (Power Machines); food (Cherkizovsky Plant); defense (aviation association Irkut); trade (Perekrestok trading house); and energy (Belon). There also are a few multi-industry holding companies, such as AFK Sistema. Many more companies are planning to raise capital through private placements.

Corporate governance must be abundantly evident in these companies' existing operations as well as in their strategic plans going forward. It is clear that the Russian business community is beginning to realize that effective corporate governance helps to achieve a sustainable balance of different stakeholders' interests. In the end, it produces enhanced shareholder value, the protection of shareholder rights and greater management accountability.

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The Russian business community has demonstrated its belief in strengthened corporate governance practices as illustrated in the following initiatives:

1. Companies are declaring in formal documents their corporate governance policies, such as procedures for annual meetings, role of the board of directors, board committees, executive bodies, audit committee and disclosure policy. These documents incorporate the latest requirements of corporate legislation as well as recommendations in the Code of Corporate Conduct, and those proposed by international organizations and influential investor associations.

2. Companies, particularly industry leaders, are developing and implementing internal codes of corporate governance that hold to higher standards than those required by law. Several companies – including Sberbank, RAO UES Rossii, YUKOS, and Magnitogorsk Metallurgical Combine – have drafted such codes. An additional 10 companies have announced their intentions to draft internal codes. They include corporations in the telecommunications sector (all Svyazinvest subsidiaries; Rostelecom), oil (Sibneft) and metallurgical companies (Severstal), RAO UES' largest subsidiaries, as well as many companies that plan to issue IPOs.

3. Many Russian executives acknowledge that corporate governance in their companies is far below standards prescribed by law, international “best practices” and investor recommendations. A 2003 survey by the Russian Union of Industrialists and Entrepreneurs (RUIE) showed that 62% of companies believe that the level of corporate governance in Russia needs to be raised. More than 50% of the polled RUIE members say the governance level in their companies is “below average.” Companies that plan to trade their shares on the stock market or issue debt securities in the next three years (80% of the respondents) intend to improve the quality of their corporate governance. Similar findings were reported in a November-December 2002 IFC-supported survey of 307 regional mostly mid-sized companies. (58)

At the same time, many top managers of large and leading mid-sized companies do not adequately understand the connection between strengthened corporate governance and attracting investment. Many of them still believe their own funds, or short-term debt, are sufficient for development, or that a profitable industrial plant and positive financials will attract investors.

3.2.

MANAGEMENT/GOVERNANCE AND CONTROL BODIES IN RUSSIAN COMPANIES

Corporate Practices Involving AGMs

Over the past few years, there have been positive changes in the way Russian companies prepare for, and conduct, AGMs. This is particularly true in the areas of regularity, notification of shareholders, drafting agendas, compliance with the AGM authority, voting procedure, and vote count. The 1990s practice of intentionally conducting meetings in remote locations has become an exception -- even for companies that operate in remote regions. Shareholders now have more opportunity to prepare for the AGM as they are informed in advance about the agenda and issues for discussion. Agenda items initiated by managers or large shareholders after the notice has been sent out are not permitted.

Shareholders who believe their rights have been neglected at general meetings can file a petition in court and request that the decisions be invalidated. At the same time, unfortunately, some minority shareholders have abused this right.

Concurrent general meetings held by conflicting shareholder groups remain a problem. Current rules allow for a separate general meeting at the request of a shareholder, who owns more than 10% of the voting shares, if the board has declined the request. This provision is directly aimed at protecting minority shareholder rights, in the absence of clear legislation and where most seats on the board represent controlling shareholders. One solution could be to amend the law On Joint-Stock Companies to provide for a dispute resolution in court if the board refuses to convene a general meeting at the request of shareholders holding 10% of voting shares.

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Board candidates are nominated by shareholders themselves, and do not require their approval by the standing board. Most minority shareholders, particularly international ones, use this right broadly and nominate candidates. The practice of pooling minority shareholder votes to elect candidates is increasingly common, and minority representatives are regularly elected to boards. Since 1999, the Association for the Protection of Investor Rights has supported these actions, mostly among foreign minority shareholders. The Organization for the Protection of Investor and Shareholder Rights plays the same role with respect to small Russian shareholders.

Separation of Management and Board Responsibilities

The results of audits carried out by regulators show that the positions of CEO and chairman of the board are separated in all large Russian companies and in many mid-sized ones. According to RID data, the percentage of non-executive directors in many boards has also increased.

According to an above-mentioned IFC survey of 307 companies 32% of medium-sized regional company boards have no executive directors. Overall, there is one executive director for every fourth non-executive director

in the polled companies. Russian law requires at least three-fourths of all board members must be non-executive directors.

Given the shortage of managers trained in a market economy, the addition of such experienced directors can bring significant benefits. Boards of directors, particularly in large companies, have strengthened their oversight of management with regard to the approval of strategy, large transactions and restructuring. Companies also are complying with statutory requirements for the minimal number of board members and election of the board by cumulative voting. Though most board seats are still held by people closely affiliated with management, independent directors now include prominent international business persons.

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In January 2004, U.S. analytical agency Energy Intelligence published corporate governance ratings of the leading multinational oil and gas companies. * YUKOS was rated second, Sibneft was eighth, and LUKOIL was eleventh. The average score was 59.7 for U.S. companies, 53.9 for the European ones and 52.8 for Russian companies. Despite Russia's third-place finish, the three Russian companies ranked higher than several leading Western corporations.

A few companies have established special internal committees, such as audit, corporate governance, nominating and compensation. Prior to 2002, only four or five companies traded on foreign exchanges had such committees on their boards.

Meeting Investor Demands for Improvement

Boards in most companies will need to make major enhancements to their governance practices if they are to meet investor requirements. Existing board practices are largely influenced by controlling shareholders who are also managers. In contrast, international best practices are based on companies with diversified ownership. They

* The rating evaluated the board by several indicators, each scored by the 100-point scale: number of members; chair and CEO positions are separated; the size of stake owned by directors; independence of the board and its committees; and regular re-election of the board members.

require that control and authority reside with independent directors who represent all shareholders – both large and small -- who do not take part in management. Clearly, this model must be modified in an environment where the CEO is often the controlling shareholder. Though these shareholders must act on behalf of all shareholders, they also carry higher risks than other shareholders. They have the strongest motivation for improving the company's long-term development. They may also be greatly tempted, however, to use their position for their own benefit, particularly in crises.

Improvements in corporate governance standards can be seen in the following:

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- Some Russian companies buy liability insurance policies for their boards and top managers. Policies were long ago recognized as constructive in protecting the rights of shareholders, as insurers will carefully look into corporate governance and risk management systems of the company before issuing such a policy. Top international companies (such as AIG and Allianz) are providing this coverage in Russia, and Russian insurance companies have begun to offer similar services
- Corporate secretaries are developing as a profession and, thus, improving communication between the company and its shareholders. Companies also have created investor relations departments to improve communication
- Experienced expatriates are being hired as operating managers in large Russian companies. At the same time, leading Russian managers have strongly improved their experience, knowledge and qualifications
- Companies have established collective executive bodies (i.e., management boards) mandated to make decisions on issues that significantly impact shareholder interests. According to IFC, management boards were established in 21% of surveyed regional companies with shareholders ranging from 50 to 1,000, and in 33% of companies with shareholders exceeding 1,000
- Top manager compensation packages are being linked to company performance, including increases in market value. Blue chips and internationally traded companies

3.2.

Management/Governance and Control Bodies
in Russian Companies

are including options in top management compensation packages. The lack of development of the Russian market limits the use of this instrument in other companies. In general, outside shareholders perceive compensation programs in almost all companies as non-transparent. They believe top manager compensation is rarely linked with increases in corporate value. This problem goes beyond Russia and is relevant for all countries, including developed markets.

**3.3.
DISCLOSURE PRACTICES**

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Disclosure of information about company performance is an important component of corporate governance. A resolution issued by the Federal Commission on the Securities Market in May 2002 required joint-stock companies to disclose the following when preparing for general meetings: the company's position in its industry; development priorities; the board report; main risk factors; biographies of board members, executive management, members of the collective executive body and their share ownership; criteria for and size of compensation paid to these persons; and compliance with the Code of Corporate Conduct. The annual report must be signed by the chief executive and chief accountant.

Levels of Disclosure

Companies have reported progress in their disclosure practices. In September 2002 and 2003, Standard & Poor's surveyed the transparency of 45 Russian companies, including 18 companies on S&P/IFCI. Those companies represent approximately 98% of total capitalization of the Russian stock market. S&P experts reviewed the quality of disclosures, particularly as perceived by international investors, by using 98 parameters related to the structure of ownership, relations with investors, financial and industrial figures, composition of the board and management. In 2002, they concluded that the transparency level in Russian companies was consistent with figures reported by Latin

American companies. The 2003 survey found positive changes in some areas. Although the level of disclosure reached or exceeded 50% of the maximum in only three Russian companies in 2002, the 2003 survey identified 12 such companies. The average level of disclosure by surveyed Russian companies increased to 40% in 2003 from 34% in 2002.

The survey showed that disclosure levels were very uneven. The quality of disclosures by several corporations at the top of the ranking list (Wimm-Bill-Dann, MTS, Rostelecom) is the same as many Western companies. The companies lower on the list, however, disclose much less information, and the disclosures by companies at the bottom are clearly insufficient.

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Some of the largest Russian companies – LUKOIL, AFK Sistema, Norilsk Nickel, United Heavy Machines, Magnitogorsk Metallurgical Combine, SUAL-Holding and YUKOS – have disclosed their beneficiary owners over the past two years. The most visible progress in transparency was in the disclosure of key industrial indicators and more complete financial statements. The volume of disclosed information about candidates and members of the board and top managers also increased.

Yet positive change in disclosure practices, even to comply with the law, is still rare. Disclosure of compensation paid to executives and beneficiary real owners is particularly lacking. Beneficiary owners usually are represented by companies registered offshore. Therefore, international cooperation in regulating offshore business should be expanded. In addition, foreign institutional investors must be more consistent in their demands for information about shareholders and beneficiary owners.

Important steps were taken to have Russian companies comply with IAS. In particular, the government decided that publicly traded companies must make consolidated reports beginning in 2005. Professionals in the securities markets are expected to use IAS beginning 2005. Clearly, the move to IAS is important, especially for large and mid-sized companies that intend to borrow on the international markets. It is

also important for Russian financial institutions that are strongly advocating an accelerated move to IAS.

In order to secure an effective transition to the International Accounting Standards (IAS) the Russian Union of Industrialists and Entrepreneurs initiated the establishment of a “National Organization on the Standards of Financial Accounting and Reporting” Fund. Participants of the Fund are representatives of the major Russian companies, investors, auditors, government structures, assessors, and scholars. The Fund promotes for a gradual transition of the Russian companies to the IAS both at the level of consolidated accounting, and on the level of accounting of individual corporations, which are part of major companies.

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3.4. PROTECTING RIGHTS AND INTERESTS OF SHAREHOLDERS

Positive changes occurred in the past few years in upholding the legal rights and interests of shareholders during major corporate actions (large transactions, debt creation, restructuring, consolidation, mergers and acquisitions, and payment of dividends). Under the current law, large transactions are those that involve at least 25% of the company's assets and require compliance with special procedures. Many companies extend these procedures to much smaller transactions, commonly as low as 5% of total assets. Some companies set this threshold even lower. For example, Svyazinvest and its subsidiaries have internal corporate standards requiring such procedures for all transactions exceeding 0.5% of total assets.

Several large companies have carried out successful restructuring consistent with the rights and interests of all shareholders in this process. Examples include Norilsk Nickel and Svyazinvest. Minority shareholders made their concerns known at the initial stage of restructuring. In both cases, restructuring led to a large increase of the company's market value to the benefit of all shareholders. The largest energy company, RAO UES, set up a special board committee headed by a

representative of Western minority shareholders with a view to strengthening investor oversight of restructuring. Experience shows that conflicts between management and minority shareholders during restructuring often result from lack of experience and poor communications rather than intent to impair shareholder rights.

Shareholders also complain about merger practices in Russia, where the law entitles the buyer gaining control to establish full control over the company. Minority shareholders may require that their stake be bought out but they may not deny such shareholder control of the company, unless there has been a violation of the law.

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Dividend Practices

A shareholder's basic right is to receive a fair share in the value of the company and its profits. Dividend payments strongly influence a company's attractiveness to investors. Russian companies usually seek to minimize dividend payments, and many do not pay dividends at all. This is partly an economic consideration, as many companies, particularly mid-sized ones, require funds to modernize their outdated facilities. Companies that post large profits and seek to attract investors, however, began paying sizable dividends in recent years. Ninety-five Russian companies reporting the largest profits paid dividends of Rub 31.1 billion in 2001 and Rub 82.7 billion in 2002. Most oil companies paid 15-22% of their annual profit in dividends. Uralkalii paid over 40% of its net profit in dividends in 2002. Norilsk Nickel and Severstal also paid large dividends at the end of the third quarter of 2003. Analysts say leading companies will pay over 40% of net profit in dividends in the coming period.

According to IFC, dividends were paid by over half of companies with turnover above \$10 million and 30% of companies under \$10 million. The share of net profit paid out in dividends increased from 16% in 2000 to 21% in 2001.

Some Russian companies have frequently delayed scheduled dividend payments to shareholders. Less common has been a disparity in payments to different groups of shareholders. More companies will pay

dividends as the economic situation improves, laws are amended to encourage dividends and companies have stronger incentives to increase their capital.

3.5. CORPORATE SOCIAL RESPONSIBILITY

The largest companies – Norilsk Nickel, LUKOIL, YUKOS, SUAL-Holding, Rusal and Vimpelcom – have significantly expanded their charitable and community activities in the past years. These include environmental programs; student scholarships; support for museums, theaters and children’s creativity centers; donations of computers and school equipment to rural schools; and housing loans to employees and pensioners.

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According to the UK-based organization, Charities Aid Foundation (CAF Russia), Russian corporations spend about \$500 million a year on corporate philanthropy and social programs. Eighty percent goes to municipal and local authorities and 20% to orphanages and arts centers. According to company records, Norilsk Nickel spent \$100 million from 1997-2003 to relocate residents of Norilsk from the arctic regions to European Russia. Severstal spent \$30 million on social projects in 2002.

In spring of 2003, the independent Center for Economic and Financial Studies, Helsinki School of Economics and Bank of Finland’s Institute of Economics in Transition polled 404 large and medium-sized industrial companies (excluding the energy industry) in 40 Russian regions. The poll showed that companies spent 8.4% of their payroll to finance social services in 2002, totaling Rub 97 billion (0.9% of GDP). Many companies received tax benefits for funds spent on such social programs.

Social Responsibility of Companies

The Russian business community is increasingly aware that corporate social responsibility is broader than philanthropy. This is consistent with practices in developed economies where corporate social responsibility can be a factor in market value by lowering

transaction costs, increasing productivity, boosting sales and enhancing customer loyalty. To date, however, social responsibility has not had a meaningful economic effect in Russia. One area where companies can have such an effect is in environmental protection. Recycling by companies will help lower costs of removing and disposing industrial waste, and realize profit from recycled materials. Reliable compensation and pension programs should reduce absenteeism and turnover rate resulting in increased productivity.

In late November 2003, the Bureau of the Russian Union of Industrialists and Entrepreneurs (RUIE) established a committee on social responsibility of large business. Its chief mandate is to coordinate business activity related to education and health care systems, and to make consumer and mortgage credit more easily accessible to citizens. RUIE is planning to introduce international standards of social responsibility in Russia and is drafting ratings of corporate social and environmental responsibility.

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3.6.

IMPROVING CORPORATE GOVERNANCE

The first steps in applying advanced corporate governance standards have been taken by Russian stock exchanges. In 2003, they introduced new rules for listing securities. Issuers whose securities are on high-level quotation lists must now comply with key provisions of the Code of Corporate Conduct and generally accepted principles of dividend policy. Unit investment funds are required to examine corporate governance practices in companies whose securities they buy.

Business leaders have been consolidating, drafting and implementing these professional standards. The Association of Managers publishes semiannual rankings of 1,000 leading Russian managers evaluated in relation to seven criteria. Manager performance in corporate governance is a key criterion. The Association of Specialists in Investor Relations was founded in Russia in 2002. It drafts standards in this

field and works toward improving its members' expertise.

In March 2003, the largest Russian issuers, investors, RUIE, CCI and FCSM created the National Council on Corporate Governance to integrate advanced corporate governance standards with the day-to-day operations of Russian companies. Also a group of leading Russian companies established the Russian Institute of Directors (RID), to help introduce standards for board members and support the election of independent directors.

*Developing Progressive Approaches
to Dispute Resolution*

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A system of alternative dispute resolution is also being established in Russia. In 2002, RUIE adopted the Charter of Corporate and Business Ethics and established an arbitration panel. This panel includes 60 of the largest Russian businessmen, government officials and experts. The panelists initially addressed only breaches of corporate ethics where both parties voluntarily agreed to take part in the arbitration. In November 2003, however, they decided to begin considering a complainant's petition even if the opposing party refuses to be present. The board can penalize business people who breach the norms of business ethics by identifying them on a list of unreliable partners and releasing these names to the media and publishing them on websites of leading business associations.

This practice has been winning support and is spreading. The business community of Rostov, capital city of the Southern Federal District, set up a commission on business ethics in November 2003, and used the RUIE arbitration panel as the model. Fifteen well-known and respected businessmen and leaders of industry associations were elected to the commission. The arbiters pass ethical judgment on the behavior of business people who have had complaints brought against them. Three out of 15 arbiters will take up resolution of any dispute -- the conflicting parties will each choose one, and the

commission chairman will appoint the third arbiter. The arbiters intend to use the RUIE Charter of Corporate Ethics and the Code of Corporate Conduct in resolving disputes.

Industry and professional associations have begun drafting codes of best corporate governance practices and business ethics. Ice cream, confectionery and alcohol producers are examples. The Russian Code of Advertisement was adopted in late 2002. It regulates the relationships of different parties in the advertising business. Work is in progress on professional codes of auditors and accountants. Their effectiveness will largely depend on how consistent all parties are in compliance with code principles.

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Investors recognize and reward improvements in corporate governance. Improvements have varied from company to company, however. Large companies who seek to increase capitalization and attract investors are improving corporate governance. Their goals may be to attract strategic investors, gain better terms of borrowing, enter foreign markets or mount joint projects with foreign companies. They view the Code of Corporate Conduct as an important guide in drafting internal standards of corporate governance. Even these companies, however, are inconsistent in corporate governance practices and introducing the Code of Corporate Conduct. Only a few leading companies fully comply with all best practices and Code provisions.

Outstanding issues include:

- Developing a clear information policy, publicly disclosing it and implementing it
- Increasing the volume of information disclosed about a company's performance, particularly with respect to ownership structure, role of the board and compensation of top managers
- Developing and implementing a clear dividend policy
- Drafting performance evaluation criteria and procedures, and regularly evaluating the board, its members and top managers
- Developing specific criteria for board and management compensation, and disclosing such information

- Establishing internal committees, chaired by non-executive directors, and publishing documents that describe committee functions and authority
- Guiding boardroom work by clear professional and ethical standards
- Building internal control systems
- Setting procedures to identify and resolve conflicts of interests
- Establishing procedures to guide key corporate decision-making.

Leading Russian companies can expect recognition of their corporate governance achievements from long-term investors who manage pension and insurance funds. Large investments made on the Russian market or purchases of Russian equities abroad will be a powerful incentive for companies to improve corporate governance and move toward best practice standards.

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Special Situations of Government Controlled and Smaller Companies

Certain large assets still remain under federal and municipal ownership. A key task for government representatives on these boards is to promote advanced norms of corporate governance. The former Ministry of Property Relations and FCSM co-drafted directives for boards of directors (supervisory councils) of open joint-stock companies with federal ownership. These directives guide implementation of Code provisions. In general, though, representatives of federal and regional governments on joint-stock company boards are not doing an effective job. If the situation is to be improved, coordination must be strengthened among agencies that handle corporate governance issues. Secondly, focus must be on companies whose strategy is to use the public markets to raise capital.

The highest priority task for regulators, the business community and investors is to help to establish a significant group of companies that are attractive investments in terms of their financial performance and their quality of corporate governance. A breakthrough beyond the limited group of 10-15 “blue chip” companies

will give investors much broader opportunities for risk diversification, make the Russian markets more liquid and growth more sustainable.

Both Russian and international experience is that the main source of investment in mid-sized companies are banks and private investors rather than the public securities markets. Evaluation of corporate governance in these companies must be addressed through negotiations between the owners and such private shareholders and lenders.

Building a comprehensive system of corporate governance consistent with international best practices may be difficult in mid-sized companies. It is associated with high cost and risk. In this area, regulatory requirements concerning disclosure and corporate governance will be less stringent than those applied to publicly traded companies.

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4 CORPORATE GOVERNANCE AND THE INVESTMENT COMMUNITY

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4.I. INVESTOR PERCEPTIONS OF RUSSIAN SECURITIES MARKETS

International investor interest in Russia plummeted immediately after the financial crisis of 1998. Having suffered billions of dollars of losses, many institutional investors preferred to cut their positions sizably or close them altogether. At the same time, they began requiring much higher interest and greater security in offering credit. The “second echelon” equity market almost ceased to exist. The situation began improving in 2000, and foreign investors started coming back to the Russian market. This process was rather long and not always consistent.

Nevertheless, some prevailing negative sentiments toward the market continue to create problems. Two of the most important are the high concentration of Russian ownership and the lack of liquidity, each of which contributes to the Russian market’s very high volatility.

In virtually all large Russian companies, management owns a percentage (25% of the voting

shares) that enables it to effectively “block” proposals by other holders. A 2003 survey by Standard & Poor’s showed that blocking stakes account for 56% of the total capital of Russia’s 45 largest companies. Not surprisingly, institutional investors hold back from investing in companies with this level of concentrated ownership.

Investors in the Russian market are prepared to take high risks because they expect high yields. Their goal is capital appreciation, not dividends. They believe the potential for such gains is great because they view Russian companies as very undervalued. Accordingly, some foreign investment funds specializing in the Russian market have achieved triple-digit annual returns. Though these investors understand – and are attracted by – the speculative nature of the markets, they nevertheless place a high priority on corporate governance.

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Russia’s 1998 financial crisis clearly demonstrated that companies with low standards of corporate governance carried higher risks than those with higher standards. In particular, many Russian banks, including the largest ones, defaulted on all their obligations and transferred assets to non-affiliated companies controlled by their majority shareholders. Moreover, Russian legislation and the judiciary system failed to support foreign investors when large-scale asset stripping occurred. This experience caused most investors to attach high importance to financial and operational transparency, as it allows them to evaluate managers’ actions promptly and to make timely investment decisions.

The Market Value of Corporate Governance

Risk-averse, more-traditional investors, such as large pension funds and insurance companies, are practically absent from the Russian equity market. Instead, they focus on developed and some emerging markets. A poll by McKinsey revealed that none of the 200 largest investment institutions in the world, with \$3.2 trillion in management, invested in Russia in 2000. Two years later

some expressed interest, yet still allocated very small amounts to Russia. S&P/IFCI (the emerging market index) weighted Russia 6.36% as compared to 4.50% two years ago. Russia is 4.81% of the MSCI Emerging Markets index, up by 1.47 percentage points from two years earlier. The increase is attributable to macroeconomic, political and institutional factors, but also reflects the overall improved business culture in Russia in relation to corporate governance and corporate conduct.

To investors, the concept of corporate conduct has a very specific meaning: they expect a culture of reasonableness, fair play, honesty and forthrightness in a company's behavior in the securities markets and in business. This includes objective conflict resolution, openness and goodwill toward investors, and strict control and reliance on generally accepted accounting practices. Absent these elements, investors are not confident in the investment process and will limit investment in Russian companies. When this culture exists, however, companies can build strong and trusted relationships with government as well as investors. The McKinsey poll also showed that most investors will pay premiums for equity in companies with a high level of corporate governance.

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4.2.

SECURITIES MARKETS, DIRECT INVESTMENT AND INITIAL PUBLIC OFFERINGS

The growth of Russian capitalization-based indices proves that interest in the Russian stock market has indeed been on a substantial rise during the past two years. The RTS index (the 59 most liquid companies) rose by 58% during 2003, compared with 34% in 2002. At the end of 2003, total market capitalization totaled \$173.4 billion (RTS capitalization plus capitalization of Gazprom). The MICEX index (12 companies) increased 61% during 2003, compared with 29.2% in 2002. The 2003 trading volume of the RTS, MICEX (the main trading platform for Russian securities), LSE, NYSE and Frankfurt Stock Exchange (depository receipts to the

Russian issuers' shares) was about \$109 billion, up 69% from the previous year.

Improved sentiments about the Russian market also are evident in the increased sovereign credit ratings issued by the international rating agencies. In October 2003, Moody's increased Russia's rating from Ba2 to Baa3. In January 2004, Standard & Poor's increased the sovereign rating for Russia from BB to BB+ on foreign currency liabilities and from BB+ to BBB- on domestic currency liabilities.

The number and composition of issuers traded on the market remained steady during the past few years. Despite the strong stock market, new issues remained at a low level, both in the volume of funds raised and the number of placements. Only one Russian company conducted an IPO on the Western markets in 2002-2003: Wimm-Bill-Dann placed about 18% of its ordinary shares as third-level ADRs on the NYSE in February 2002, thus raising about \$207 million. During the same period, the Russian market saw only two offerings:

OAO Rosbusinessconsulting-Information Systems raised \$13.3 million when it placed 16% of its shares on the MICEX and RTS in April 2002, and OAO Drugstore Network 36.6 raised \$14.4 million when it placed 20% of its shares on the MICEX in January 2003.

A fundamental problem, which strongly inhibits development of the Russian economy, is that its stock market is relatively narrow. This can be seen by comparing the company proceeds from domestic and international placements, and the trading volumes in financial instruments on Russian, West European, and Asian stock exchanges. A class of domestic investors has not yet developed in Russia, thus deterring investment inflows. Although domestic liquidity began improving in the past few years, most additional liquidity is re-invested in the same financial instrument. This is similar to the practice in the pre-crisis period of 1997-1998, when government short-term obligations (GKO) were the favored investment. The currently favored investment is the rapidly growing, yet very speculative, corporate ruble debt. The FCSM estimated that about \$5.2 billion in

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ruble debt was outstanding as of October 2003. Domestic investment capacity will need to be increased to drive trading volume as well as the value of Russian equities. It will also be needed to draw foreign investors into the market.

Investor confidence can be measured by the volume and characteristics of direct foreign investments in a country. Direct and strategic investors are usually more conservative than public-market investors, and generally need much more time to make investment decisions. Following the 1998 crisis and the global decline in 2001, foreign direct investments (FDI) in Russia rose in 2002-2003. Their per capita volume and share of GDP, however, is still low compared with Eastern Europe and other emerging markets.

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The quality of a nation's business environment (one element of business competitiveness index measured by the World Economic Forum) is another important investment consideration. In this index, confidence in Russia's business environment decreased from 55th position in 2001 to 61st in 2003. In terms of effectiveness of government institutions, Russia ranked 68th in 2003, down from 65th in 2002. According to the EBRD institutional reform index, Russia rated 12th among 27 CEE and CIS countries. A poll of Western executives working in Russia, published by Expert magazine and SRU Limited (UK), rated the level of risk related to bureaucracy, discretionary practices and corruption of government officials in Russia as 4.3 (on a 5.0-point scale). As a result, direct investments reached 0.85% of GDP in 2002 (compared with 2.0% in Poland and 3.4% in China), and their share in the total international investments is only 0.35%.

4.3.

THE ROLE OF CORPORATE GOVERNANCE IN INVESTMENT DECISIONS

In general, more than 80% of investors polled by Standard & Poor's believe that quality of corporate governance is the main determinant in making

investment decisions. Almost all respondents reiterated their willingness to pay a premium for equity of companies with reliable corporate governance practices. Some investment companies in Russia (Troika Dialog, Brunswick UBS) compile their own corporate governance rankings and use the rankings in determining the fair price of shares for their clients.

Strategic investors take a similar but qualified position. A 2003 poll by the Expert think tank found that corporate governance rated ninth in importance among 16 factors that investors assess when looking at the attractiveness of Russian investments. Ranking higher were economic growth, geopolitical importance of the country, size of its economy, the taxation system, security, political stability, labor resources and quality of communications.

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Corporate governance ranked above such factors as the quality of the legislative framework, level of service, infrastructure and transport.

Investors rely on limited sources in accessing information about the quality of corporate governance in the country. Standard & Poor's rating products are broadly distributed in the investor community. They compare practices of companies in different industries and provide independent analysis. The corporate governance score (CGS) reflects the rating agency's opinion about the level of non-financial risks, i.e., risks of ineffective or unfair governance in a company. During the past 18 months, Standard & Poor's increased the CGSs of North-Western Telecom (NWT), Aeroflot, Lenenergo and Uralsvyazinform, while earlier it had lowered the scores on NWT and Aeroflot.

The components of corporate governance affect investment decision-making in different ways, as demonstrated by a November 2003 poll of investors by Standard & Poor's (Table 1).

Table 1.

*Key Factors of Corporate Governance in Russia
(Investor View)**

FACTOR	AVERAGE SCORE
Transparency	9.1
Board effectiveness and independence	8.1
No conflicts of interests of shareholders	7.9
Compliance with corporate procedures and shareholder rights	7.6
Confidence in management	7.6
Reliable internal control procedures	7.1
Absence of majority shareholders	3.4

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* Investors were asked to give scores from 0 (lowest) to 10 (highest) on each of the seven proposed answers, or add missing factors.

Investors did not view the presence of a majority shareholder as a very important factor. This suggests it is not the presence or absence of a majority shareholder that affects corporate governance, but the lack of conflict of interests and the existence of corporate policies to balance different shareholder interests.

**4.4.
CORPORATE GOVERNANCE
AND INVESTOR PREFERENCES**

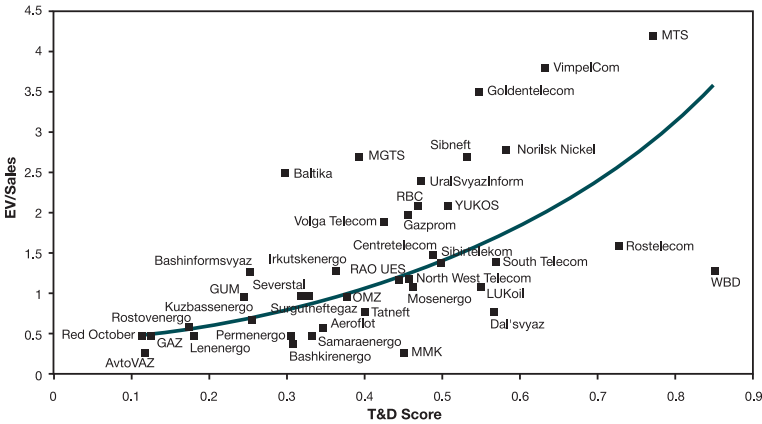
Russia’s telecommunications industry provides an example of the correlation between the quality of corporate governance and successful investor relations. Most respondents in an investor poll cited telecommunications companies, particularly the wireless companies, as the most successful practitioners of corporate governance. Indeed, the lack of conflicts and high transparency are typical of companies – such as Vimpelcom, MTS and Golden Telecom – that began operations with foreign strategic investors. Given the capital-intensive nature of their industry, it also was critical that these companies demonstrate a strong commitment to corporate governance. Early in their development, these companies had to seek funding first

from foreign private equity investors, then on public capital markets. Today, the best Russian telecoms are comparable to similar companies in Eastern and Western Europe in terms of value per one serviced user and return on investment.

Conversely, large Russian industrial groups fought to gain control over other industrial companies: ferrous metallurgy, aluminum, chemicals and wood processing industries. Minority shareholders either left these companies or were forced out. Today, investors have not returned to these sectors, as strong strategic owners prefer private ownership. These owners may eventually attempt to make public offerings, but must first build effective corporate governance to address past abuses and future confidence among investors.

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Chart 1.
Correlation Between Enterprise Value and Level of Corporate Transparency



Polled investors said the various components of corporate governance are as important as economic, political and legislative factors. Respondents noted that many companies were disclosing the structure and identities of their ownership, including beneficiary owners; issuing financial reports based on international accounting

standards, with a complete set of comments; and improving communications with minority shareholders. According to Standard & Poor's, about 33% of the private ownership of the 45 largest Russian companies had been disclosed by the Fall of 2003, compared with 29% in 2002.

**4.5.
INVESTOR CONCERNS RELATED
TO CORPORATE GOVERNANCE IN RUSSIA**

Investors acknowledge substantial improvements in Russian corporate governance, but the majority of respondents in Standard & Poor's 2003 poll still believed Russia lags behind developed economies. Corporate governance standards are still not high enough, and this remains a factor that hampers market growth (Table 2). (80)

Table 2.
*Main Problems of Corporate Governance in Russia
(Investor View)**

FACTOR	AVERAGE SCORE
Conflicts of interests between the majority and minority shareholders – the majority shareholders are likely to abuse the control functions	8.3
Non-transparent structure of ownership	8.3
Related party transactions, asset stripping, weak internal controls	8.3
Information opacity, unequal access to information	7.4
Inefficient management	6.9
Management does not inspire confidence	6.7
Abuses during reorganization/move to a single share	6.6
Absence of well performing and independent boards of directors	6.5
Concentrated structure of ownership	6.3
Irregular/untimely payment of dividend	4.8
Obstacles for taking part in the meetings of shareholders	3.4

* Investors were asked to give scores from 0 (lowest) to 10 (highest) on each of the 11 proposed answers, or add missing factors, while evaluating the importance of each factor of corporate governance.

Investors evaluate corporate governance risks primarily in terms of their possible impact on returns. Risk of direct loss of assets, of course, is given a higher weight than risks related to poor governance that might result in operating losses, but not total value. Loss of assets has been seen in potential asset stripping and non-market transactions. These are usually transactions by majority shareholders with people closely affiliated with management. In some companies, the possibility of asset stripping through transfer pricing, sale of assets at below-the-market prices or using assets as security with a subsequent default on obligations is still high.

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In the history of Russian business, corporate value often has been damaged by corporate wars, certain actions during actual or planned reorganizations, or ignoring the interests of investors. Minority shareholders were the first to lose from these actions. In the intermediate stage of reorganization, valuable assets were stripped or opportunities for stripping were built into the process. Afraid that their interests could be strongly impaired, the minority shareholders began selling their shares, thus depressing the company's market value.

There are, however, cases where executives took steps to improve the situation. The executives of RAO UES Rossii initiated a dialogue with minority shareholders and incorporated their requirements as restructuring progressed. Nevertheless, many investors still have concerns that their interests might be impaired in the course of allocating shares in the resulting companies of RAO UES' most attractive assets.

Investors view insufficient or inadequate disclosure as another major problem. Investors point to Gazprom as an example of non-transparent operations whose executives are reluctant to share financial information with investors. They also point to problems in the communications industry that traditionally has been the most transparent of all sectors in the Russian economy. For example, regional subsidiaries of Svyazinvest make unidentified payments of 1% of their annual earnings to an obscure entity that has not been

explained to investors. Svyazinvest' companies transactions to buy an Oracle-based resource management system raised questions about high cost and the absence of tender procedures. In other cases, companies have sold assets without holding tenders. The buyers in these transactions are legal entities, but with a non-transparent structure of ownership that could be obscuring conflicts of interests.

Investors also are very concerned about compensation plans for management and board members. They believe management and board compensation should (i) link personal interests with the interests of all shareholders, and (ii) promote the long-term growth of company value. To date, most Russian companies have not emphasized equity or stock options as an important component in compensation packages. Currently, only those public companies with a large float (e.g. MTS, Vimpelcom and RAO UES) link compensation to the value of their shares.

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About one-third of investor respondents believe management compensation is sufficiently linked to financial performance. Nearly half agree that this statement is true for at least some companies (in many cases, investors do not have access to any compensation information). As for board compensation, they said there are no procedures for evaluating the performance of the board or its members; and non-executive directors are not motivated to achieve long-term results.

Investors do not perceive irregular or untimely payment of dividends as an acute problem. In contrast, this was a main complaint of minority shareholders a few years ago. About one-fourth of the polled investors said all or many recipient companies pay dividends on time. The rest state that only some companies pay timely dividends. More than one-third of respondents say all or many Russian companies pay the actual promised amount of the dividend payment.

There are problems when dividends are paid over too long a period, usually six months (the law does restrict the company's discretion on timely payouts). Given high inflation, this devalues accrued amounts.

The situation is sometimes exacerbated when companies set a sequence of payments that allows some shareholders to receive their dividends earlier than other shareholders.

Investors usually understand a company's rationale for reinvesting profit for development rather than paying dividends. At the same time, only one-fifth of investors polled by Standard & Poor's believes that the amount of dividends paid out is appropriate.

4.6.

THE ROLE OF BOARDS AND MINORITY SHAREHOLDERS IN RUSSIAN PUBLIC COMPANIES

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The Standard & Poor's poll reveals that investors do not yet have strong confidence in the management of Russian companies. This is largely explained by the history of corporate wars and scandals, as well as the fact there are few effective corporate governance bodies that can protect investor rights and interests, i.e., independent boards of directors. This, of course, is a result of the concentrated ownership structure in Russian companies, where most or nearly all board seats are taken by the controlling or large shareholders. Standard & Poor's October 2003 survey of board structure in the 45 largest Russian companies showed that majority shareholders and management held 30% and 24 % of the seats on boards, respectively. Russia does not yet have enough respected and trusted business executives or academics who can serve as independent directors.

Many foreign investors are very active in advocating the principles of corporate governance and are ready to serve on boards, although their holdings may not be large and they do not always have long-term interests in the companies. At the time of the poll, 38 % of respondents were board members in Russian companies. In corporations that have large or majority shareholders, the role of foreign investors can be more significant in Russia than in the West. For instance, they are highly focused on the fact that their return on investments in this highly volatile market depends largely on their

participation in corporate governance. The implementation of cumulative voting, as provided in the law On Joint-Stock Companies, is an important positive step in this regard as it helps to elect representatives of minority shareholders even when there is concentrated ownership. According to the S&P survey, 56 board members at the 45 largest Russian companies (or 12% of all directors), represented minority institutional investors. Another 45 members, or 10% of all directors, represented strategic minority shareholders.

In some cases, a board seat can generate a conflict of interest. One example is a director who is supposed to represent minority shareholders but at the same time is an institutional investor privy to confidential information that can move stock value. Nevertheless, board participation can help small investors offset the significant influence of majority or large shareholders. They also can press to have minority interests considered on issues that are highly important to them. Although generally it is difficult to change decisions on most issues, because their votes do not outweigh the majority owner, there are exceptions: cases where voting is tied to related-party transactions where majority shareholders cannot vote because they have compromising interests.

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In some cases, directors who represent minority investors do not have enough information about the company's operations. Materials sent to board members often lack answers to key questions, such as the material conditions of transactions, structure of partners' ownership, or the economic grounds of proposals or decisions made. They also may not be given information on related-party transactions.

4.7.

THE PROBLEM OF SMALLER COMPANIES

Corporate governance abuses in large Russian companies have recently become much less frequent. In the case of small and medium companies, however, investors still are discouraged by the quality of disclosure. Violations of small investor financial rights are almost common

practices. These companies do not attract institutional investors, developing as private companies based on their own financial resources or on limited borrowing. Small public companies, however, often fail to meet most institutional investor criteria. First, most are not of sufficient size in terms of capitalization, free float and revenues. Second, investors do not trust management or controlling shareholders. High growth and good financial performance is constrained by low corporate governance standards, and investors avoid such companies.

As a rule, they are ready to invest only if they can obtain a large stake, at least the blocking one. This strongly narrows the range of potential investors and, in smaller companies, practically eliminates the prospect of institutional investment. Institutional investors are prepared to take part in corporate governance only if the value of their stakes can be of meaningful size and have significant growth prospect. Companies with sales below \$300 million cannot offer such opportunities. The time required for their involvement outweighs the opportunities.

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Strategic investors as well as institutional investors view control as the main means of avoiding the loss of assets. If transparency and strong corporate governance systems are in place to protect investors, these professionals could help Russian companies strengthen their business and even bring them to the public markets. To attract strategic investors, private companies should offer them the opportunity to take part in corporate governance and demonstrate their readiness to put required procedures in place.

There are few such companies in Russia at this point. Recent developments include the investment by the Fleming board in SUAL-Holding, a larger share of Pulp Mill Holding GmbH in Arkhangelsk Pulp and Paper Mill, Templeton's interest in Perekrestok [Crossroads] trading house, and foreign strategic investor purchases of assets in the machine engineering, perfume, food and household chemicals industries. Another development in governance is establishing joint companies with pre-

determined procedures that assure equal influence of shareholders. By far, the most significant example has been the joint venture of British Petroleum and Tyumen Oil Company in 2003.

Legislation and judicial procedures play an extremely important role in building and enhancing investor confidence. Many investors avoid Russian courts because litigation is time-consuming, and the likelihood of receiving adequate compensation is slim. Although nearly all investors in the S&P poll faced corporate governance problems, only one-fifth of them turned to the courts for resolution. They managed to win very few cases. International experience proves that the objectives of improving corporate governance and attracting large-scale investments cannot be achieved unless reliable mechanisms for legal and court protection of investors are put in place.

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The purpose of this report is to summarize the recent developments in Russia's corporate sector and related changes in corporate governance. The report shows an important progress in Russian companies' practice and legislation. There is growing understanding in the government and in the business community that shared values and common principles with respect to corporate governance are essential for maintaining long-term growth and investment. The report also identifies key avenues for future work on improving corporate governance.