



INTERNATIONAL FINANCE CORPORATION  
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Good corporate governance contributes to a company's competitiveness and reputation, facilitates access to capital markets, and thus helps develop financial markets and spur economic growth. With this in mind, the International Finance Corporation and the U.S. Department of Commerce have combined their efforts to provide Russian managers, directors, and shareholders with a practical tool to implement good corporate governance practices – the Russia Corporate Governance Manual. This Manual refers to and is based on the principal laws and regulations that apply to open joint stock companies. It follows the recommendations of the FCSM's Code of Corporate Conduct and refers to internationally accepted principles of good corporate governance.

*“Corporate governance is vital to the interests of every economy, and government has a role to play in establishing the framework for reform - but it is companies that have the tough job of putting governance reform into practice. This is where the Corporate Governance Manual can provide excellent help. It offers a comprehensive workbook for company directors, officers, and advisers in taking up the challenge of corporate governance improvement. Shareholders and stakeholders alike should applaud IFC for bringing practical, and professional advice within reach of every boardroom.”*

**Anne Simpson**, Manager,  
Global Corporate Governance Forum

*“Corporate governance reform in Russia is the continuation of the more general processes of change affecting the country as a whole. Taken together, these developments have created a new environment, new rules regulating the relationships between the market and regulators, between shareholders, shareholders and managers, etc. In the business community there is a growing awareness of the benefits of corporate governance reform, and companies are now working on improving the quality of their corporate governance ...”*

**Ruben K. Vardanian**, President of Troika Dialogue; Chairman of the Board,  
OJSC Rosgosstrakh; and Chairman of the RSPP Corporate Governance Committee

*“Good corporate governance is a key driver of financial transparency and managerial accountability, essential ingredients for national prosperity in a global economy. We congratulate the U.S. Department of Commerce and the International Financial Corporation of the World Bank for their initiative in bringing about the publication of the Russia Corporate Governance Manual.”*

**Andrew B. Somers**, President,  
American Chamber of Commerce in Russia

Questions on corporate governance should be addressed to the IFC Russia Corporate Governance Project, via [CGPRussia@ifc.org](mailto:CGPRussia@ifc.org)

An electronic version of the Manual is available on the website of the International Finance Corporation under [www.ifc.org/rcgp](http://www.ifc.org/rcgp) and the U.S. Department of Commerce under [www.mac.doc.gov/ggp](http://www.mac.doc.gov/ggp)

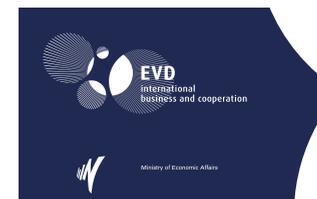
# The Russia Corporate Governance Manual

## I Part I Corporate Governance Introduced



Prepared and Published by the International Finance Corporation and the U.S. Department of Commerce

In Partnership with the Agency for International Business and Cooperation of the Dutch Ministry of Economic Affairs and the Swiss State Secretariat for Economic Affairs



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# The Russia **Corporate Governance** Manual

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## Part I

### **Corporate Governance Introduced**

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and the U.S. Department of Commerce

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All references to the male gender throughout this Manual apply to both sexes, unless otherwise indicated.

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*“Russia has a strategic goal: to become a country that makes competitive goods and renders competitive services. All our efforts are committed to this goal. We understand that we have to solve questions pertaining to the protection of owners’ rights and the improvement of corporate governance and financial transparency in business in order to be integrated into world capital markets.”*

President Vladimir Putin  
at a Session of the World Economic Forum,  
Moscow on 30 October 2001

*“All successful companies are successful in the same way.  
All unsuccessful companies are unsuccessful in different ways.”*

Adapted from Leo Tolstoy’s “Anna Karenina”

# The Importance of Good Corporate Governance for Russia

During the last decade, policy makers, regulators, and market participants around the world have increasingly come to emphasize the need to develop good corporate governance policies and practices. An increasing amount of empirical evidence shows that good corporate governance contributes to competitiveness, facilitates corporate access to capital markets, and thus helps develop financial markets and spur economic growth.

Today, both domestic and foreign investors place an ever greater emphasis on the way that corporations are operated and how they respond to their needs and demands. Investors are increasingly willing to pay a premium for well-governed companies that adhere to good board practices, provide for information disclosure and financial transparency, and respect shareholder rights. Well-governed companies are also better positioned to fulfill their economic, environmental, and social responsibilities, and contribute to sustainable growth.

Improvement in corporate governance practices can improve the decision-making process within and between a company's governing bodies, and should thus enhance the efficiency of the financial and business operations. Better corporate governance also leads to an improvement in the accountability system, minimizing the risk of fraud or self-dealing by company officers. An effective system of governance should help ensure compliance with applicable laws and regulations, and further, allow companies to avoid costly litigation. Also, Russian companies should stand to benefit from a better reputation and standing, both at home and in the international community.

It is with this in mind that the International Finance Corporation — a member of the World Bank Group — the U.S. Department of Commerce, and the governments of the Netherlands and Switzerland have combined their efforts to provide Russian open joint stock companies with a practical tool to implement good corporate governance practices. The Russia Corporate Governance Manual outlines structures and procedures for establishing and maintaining effective corporate governance, and shows how the various parts of a company interact. In addition, model internal corporate documents and other practical tools are annexed to assist companies in implementing the many recommendations made throughout this Manual. The Manual targets those individuals directly involved in the governance of Russian companies (Russian shareholders, directors, and managers) and

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is designed to inform them of their respective rights and responsibilities within the corporate system.

As most of Russia's large and mid-size enterprises were privatized into open joint stock companies, this Manual refers to and is based on the principal laws and regulations that apply to open joint stock companies. In addition, it follows the recommendations of the Russian Code of Corporate Conduct, developed under the auspices of the Federal Commission for the Securities Market. Finally, the Manual refers to generally accepted international principles of corporate governance.

We at the International Finance Corporation and U.S. Department of Commerce look forward to continued cooperation with Russian companies, market participants, government authorities, and other stakeholders in advancing ongoing corporate governance reforms. A concerted effort can move the corporate governance debate from theory to practice, helping Russia in its progress toward a better business and economic environment.

Donald L. Evans  
Secretary of Commerce  
U.S. Department of  
Commerce

James D. Wolfensohn  
President  
World Bank

Peter L. Woicke  
Executive Vice President  
International Finance  
Corporation



## Forward by the Federal Service for Financial Markets

The development of financial markets in Russia is inseparably linked to corporate governance reforms. The quality of corporate governance is one of the key factors affecting the country's investment climate.

Political and macroeconomic stability in Russia have resulted in high rates of economic growth and have created a favorable environment for Russian businesses to shift their strategic focus from short-term to long-term development. Positive changes have also occurred in the legal and regulatory corporate governance framework. New regulations provide for better shareholder rights protection, establish new rules for conducting General Meetings of Shareholders, and significantly improve information disclosure regimes. The national corporate governance standards set forth in the Code of Corporate Conduct have established a comprehensive benchmark for analyzing corporate governance practices and formulating standards of corporate ethics.

Compliance with the provisions of the Code of Corporate Conduct will make companies more transparent and thus attractive to potential investors. Recent developments demonstrate that corporate governance improvements are beginning to be viewed by Russian companies as an important method to gain a competitive advantage. Compliance with corporate law and the provisions of the Code of Corporate Conduct is a necessary precondition for companies to participate in the capital markets and, as a result, reduce their cost of capital.

The Federal Service for the Financial Markets considers the translation of corporate governance principles into company practices as one of its most important tasks.

The Russia Corporate Governance Manual, developed by the International Finance Corporation and the U.S. Department of Commerce, allows Russian companies to better understand the economic value of good corporate governance, and recommends practical steps that companies may take to improve their corporate governance. I am confident that the publication of this Manual will help many Russian companies fulfill their goals and raise capital in financial markets.

O.V. Vjugin,  
Head of Federal Service for the Financial Markets



## Forward by the Ministry of Economic Development and Trade

The need to improve corporate governance is one of the key challenges faced by Russian business today. Better corporate governance, in addition to improved economic performance, allows companies to reduce their financial and operational risks, and significantly raises their attractiveness to investors.

That is why the government of the Russian Federation works systematically to improve the corporate governance framework for Russian companies. Over the period from 2001 to 2002 two fundamental corporate governance documents were published in Russia: the Code of Corporate Conduct and the White Paper on Corporate Governance. The Code of Corporate Conduct is a summary of the key principles of best corporate governance practices, setting a standard for Russian companies on how to develop their own system of corporate conduct and providing practical recommendations on how to implement these principles. The White Paper on Corporate Governance in Russia, published by the OECD together with the Russian Ministry of Economics, offers an overview of the existing state of corporate governance in the country and presents recommendations for policy makers and legislators, as well as best practices for the private sector. The publication of these documents came as a result of a comprehensive analysis of corporate governance standards and practices both in Russia and the developed economies of the West, and marked an important milestone of Russia's integration into the global economy

The Russia Corporate Governance Manual pays significant attention to the recommendations of both the Code of Corporate Conduct and the White Paper on Corporate Governance in Russia, and also provides comments on a number of the most important provisions of said documents.

At the same time the Manual takes into account not only the practices of Russian joint stock companies and the specifics of the national stock market, but also the experience of many other developed and emerging economies. The Manual further offers a vast number of practical examples based on corporate governance practices of many large and well-known international companies.

An international team of Russian and Western experts from the World Bank's International Financial Corporation prepared the Manual. Well known scholars, businessmen, specialists in finance, stock market and corporate law, including experts from the Ministry of Economic Development and Trade of the Russian Federation, participated in the preliminary discussion and reviews of the publication.

We believe that this Manual will help raise awareness of important corporate governance issues, assist our companies in strengthening their competitive position, and become a useful tool for implementing international standards of corporate governance in Russian companies.

German Gref,  
Ministry of Economic  
Development and Trade



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## About the U.S. Department of Commerce

The U.S. Department of Commerce (USDoC) seeks to increase trade opportunities for U.S. companies and promote U.S. exports and investment. Weak rule of law, lack of adequate intellectual property rights protection, and corruption create barriers to trade, investment, and overall economic development, particularly in emerging markets. To address these concerns and establish a level playing field for U.S. companies, USDoC created a Good Governance Program. Currently, the Program is engaged in activities in 11 countries in the Caucasus, Central Asia, Eastern Europe, Latin America, and Russia. The Program works with the private and public sectors in promoting sustainable reform in the following four program areas:

- Business Ethics/Anti-Corruption;
- Commercial Dispute Resolution;
- Corporate Governance; and
- Intellectual Property Rights.

The Good Governance Program encourages fairness, transparency, and accountability in corporate governance practices in emerging market economies by engaging in cooperative programs with private sector organizations and by establishing a private-public sector dialogue. In Russia, the Program supported efforts of several non-governmental organizations (NGOs) to develop an *Independent Director Code* and a *Declaration of Principles of the Professional Community of Corporate Directors*. The Program conducts intensive “train-the-trainer” programs that provide select professionals the skills and expertise to implement good business and corporate governance practices at all levels, including companies, business associations, NGOs, stock exchanges, and educational institutions.

## About the International Finance Corporation

The International Finance Corporation (IFC) is a member of the World Bank Group. IFC was established in 1956 to encourage private sector activity in developing countries. It does this primarily through three types of activities: financing private sector projects, helping companies in the developing world to mobilize financing in international financial markets, and providing advisory services and technical assistance to companies and governments.

IFC is a leader among multilateral financial institutions in integrating corporate governance considerations into all phases of the investment process. IFC’s long history of and practical experience in structuring investments, appraising investment opportunities, and nominating board members has allowed it to put corporate governance principles into action. A focus on good corporate governance practices in client companies allows IFC to manage risks and add value to its clients. In addition to the benefits to individual client companies, working to improve corporate governance,

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contributes more broadly to IFC's mission to promote sustainable private sector investment and strengthen capital markets in developing countries.

The IFC Russia Corporate Governance Project (RCGP) is a technical assistance project within the framework of the IFC Private Enterprise Partnership that aims to improve corporate governance practices in Russia. Its four main objectives are to:

- Assist Russian companies in implementing corporate governance through corporate trainings, consultations, and assessments, and thus facilitate their access to outside capital;
- Advise public sector officials on legislative and regulatory reform in corporate governance;
- Develop curricula for universities and other educational institutions to help train the next generation of managers, investors, and policy makers; and
- Support key institutions and change agents, including the press and NGOs to help build sustainable practices and raise awareness.

## About the Swiss State Secretariat for Economic Affairs

The Swiss State Secretariat for Economic Affairs (seco) is the Swiss government's department in charge of economic policy. In terms of foreign trade policy, seco is active in shaping efficient, fair, and transparent rules for the world economy.

Seco represents Switzerland in the large multilateral trade organizations as well as in international negotiations. Seco is also involved in efforts to reduce poverty in the form of economic development assistance. Its development cooperation division is the competence center for sustainable economic development and the integration of developing and transition countries and their companies into the global economy.

Seco included corporate governance in its economic development assistance programs in 2000. Its overall support for the IFC Private Enterprise Partnership and its RCGP is one such example of development assistance.

## About the EVD, the Agency for International Business and Cooperation of the Dutch Ministry of Economic Affairs

The Agency for International Business and Cooperation (EVD) is part of the Dutch Ministry of Economic Affairs. Its mission is to promote and encourage international business and international cooperation. As a state agency and a partner to businesses and public-sector organizations, the EVD aims to help them achieve success in their international operations. A growing network of organizations, government institutions, and companies have come to rely on the EVD for information about foreign markets, governments, and trade and industry. Many of them do benefit from the financial programs, previously run by Senter Internationaal and now administered by the EVD.

# PREFACE

## Background

In April 2002, the USDoC and IFC, in partnership with Senter Internationaal and seco, agreed to jointly and cooperatively develop, publish, and distribute a corporate governance manual for open joint stock companies in Russia. This effort was initiated by and undertaken in cooperation with the Federal Commission for the Securities Market, the Ministry of Economic Development and Trade, the American Chamber of Commerce in Russia, the Russian Institute of Directors, the Independent Directors Association, and the Investor Protection Association.

The RCGP along with the USDoC's Good Governance Program coordinated the development of this Manual. Representatives from the private sector, regulators, educational institutions, international organizations, the Russian government, and others provided feedback through a series of roundtables and public commentary. In total, six roundtables were organized in cooperation with leading Russian organizations active in the field of corporate governance, and the Manual was placed on the internet for further public commentary. The result of this inclusive consultation process is guidance that meets the needs of business, is practical in nature and easy to use, and provides detailed insight into the evolving Russian corporate governance system.

## Purpose and Target Audience

This Manual provides executives, directors, and shareholders of Russian open joint stock companies with a comprehensive summary of the corporate governance framework and practices prevalent in Russia today, and a practical toolkit designed to help implement good governance in practice. It provides readers with:

- An overview of the legislative and regulatory requirements related to corporate governance, as well as references to the Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code) and internationally recognized corporate governance principles;
- Recommendations on how to fulfill the governance obligations of open joint stock companies;

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- Practical examples of how corporate governance standards can be implemented, and guidance for executives and directors in meeting their obligations with respect to the governance of the enterprise; and
- General outlines of authorities, obligations, and procedures of the governing bodies of open joint stock companies.

This Manual also provides government officials, lawyers, judges, investors, and others with a framework for assessing the level of corporate governance practices in Russian companies. Finally, it serves as a reference tool for the educational institutions that will train the next generation of Russian managers, investors, and policy makers on good corporate governance practices.

### How to Use this Manual

This Manual has been divided into and is published in six parts:

- Part I: Corporate Governance Introduced
- Part II: Good Board Practices
- Part III: Shareholder Rights
- Part IV: Disclosure and Transparency
- Part V: Special Focus Section
- Part VI: Annexes

The first four parts contain chapters that focus on core corporate governance issues, such as a company's board structure, information disclosure practices, and shareholder rights. Part five focuses on corporate governance issues of particular importance in the Russian context, namely corporate governance concerns during a company's reorganization, within holding structures, and relating to enforcement. Part six, finally, offers practical tools in the form of model documents, for example company codes, by-laws, and contracts. All issues are closely examined through Russian law and regulations, the FCSM Code and, when applicable, internationally recognized best practices.

While it is recommended to read the entire Manual to gain a full understanding of the corporate governance framework in Russia, it is not necessary to read all the chapters in chronological order. The reader is encouraged to begin with a topic of interest and follow the links and references included in the text for guidance to other chapters.

Examples, illustrations, and checklists are included to make the Manual clear and useful. The following tools will reappear at various intervals in the text:

- The **Chairman's Checklist** is intended to help the Chairman of the Supervisory Board focus Board discussions on key corporate governance issues faced by companies.

**The Chairman's Checklist**

- ✓ Does the company have a clear distribution of authority between shareholders, Supervisory Board members and managers? Has the company properly established an Executive Board
- ✓ Do the General Director and all members of the Executive Board possess the knowledge and skills necessary to manage the company? Is there a transparent division of tasks among the members of the Executive Board, such as operations, marketing, finance, legal, etc.?

- **Best Practices** summarizes the main provisions of the FCSM Code, the OECD Principles of Corporate Governance, as well as leading national standards from other countries.

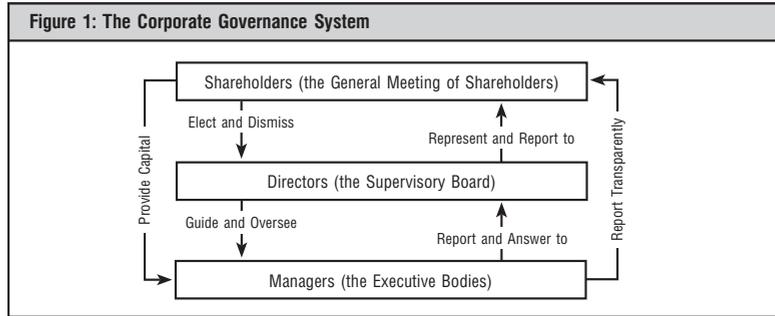
**Best Practices:** Independent directors can make a substantial contribution to important decisions of the company, especially the evaluation of executive performance and in the resolution of conflicts of interest. Independent Board members give investors additional confidence that the Supervisory Board's deliberations will be free of obvious bias.<sup>101</sup> Companies are advised to disclose information about independent Board members in the annual report.<sup>102</sup>

- **Company Practices in Russia** illustrates how Russian companies currently approach corporate governance issues. It highlights red flags, i.e. common corporate governance abuses that occur, and model company practices in good corporate governance.

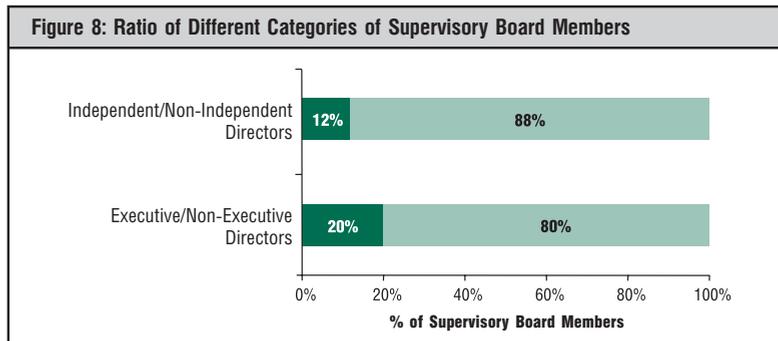
**Company Practices in Russia:** Many Russian companies are controlled by a single shareholder or group of shareholders that are well informed about the affairs of the company and able to closely monitor the company's management. On the other hand, the remaining ownership is often widely dispersed and many of these, often minority, shareholders lack the resources and information to effectively monitor management and defend themselves against the potential abuses of large shareholders. In these types of companies, independent directors take on special importance.

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- **Figures, tables, and other illustrations** are included to illustrate key concepts.



Source: IFC, March 2004



Source: IFC, Regional Survey on Corporate Governance Practices, August 2003

- **Mini-cases** illustrate abstract concepts and show the real problems that companies face.

**Mini-Case 1:** A company has 2,500 minority shareholders holding a total of 3,000 voting shares and one majority shareholder holding a total of 12,000 voting shares. The Supervisory Board has nine members. The 2,500 shareholders hold 27,000 votes (3,000 shares × 9 votes) and the majority shareholder has 108,000 votes (12,000 shares × 9 votes). The total number of votes that all shareholders can use to elect the candidates to the Supervisory Board is 135,000 votes (9 votes × 15,000 shares). The nine candidates that receive the most votes are elected to the Supervisory Board.

- Detailed references to law and regulation guide the reader to original texts.
- The IFC RCGP Corporate Governance Progression Matrix for Russian Companies is included in Annex 1 to allow the reader to assess the level of corporate governance in Russian companies, develop areas for improvement, and measure progress made.

		Level 1: Compliance with legal and regulatory requirements	Level 2: Initial steps to improve corporate governance are made	Level 3: Advanced corporate governance system	Level 4: Corporate Governance leadership
I. Commitment to CG	Legal Compliance	<ul style="list-style-type: none"> <li>✓ The company has developed and follows a valid charter according to Russian legislation with provisions on the protection of shareholder rights and the equitable treatment of shareholders, distribution of authority between the General Meeting of Shareholders (GMS), the Supervisory Board and executive bodies, and information disclosure and transparency of the company's activities.</li> </ul>	<ul style="list-style-type: none"> <li>✓ The company has developed and follows by-laws regulating the activities and working procedures of the corporate bodies approved by the GMS (the GMS, the Supervisory Board, the Executive Board, and Revision Commission).</li> </ul>	<ul style="list-style-type: none"> <li>✓ The company has developed and follows a comprehensive set of internal documents that are recommended by the Federal Commission of the Securities Market Code of Corporate Conduct (FCSM Code) and are approved by the Supervisory Board.</li> </ul>	<ul style="list-style-type: none"> <li>✓ The company has adopted a company level corporate governance code and code of ethics, and follows internationally recognized best practices of corporate governance.</li> </ul>
	Company Practice	<ul style="list-style-type: none"> <li>✓ n/a</li> </ul>	<ul style="list-style-type: none"> <li>✓ The company has a person/officer responsible for the implementation of corporate governance policies in the company.</li> <li>✓ The company follows the main recommendations of the FCSM Code and discloses information to the FCSM on a comply or explain basis.</li> </ul>	<ul style="list-style-type: none"> <li>✓ The company has a designated office(r) responsible only for ensuring the development of, compliance with, and periodic review of corporate governance policies and practices in the company (for example, the Corporate Secretary).</li> <li>✓ The company has an explicit and clearly stated plan in place to improve its governance practices and has taken initial steps to implement this plan.</li> </ul>	<ul style="list-style-type: none"> <li>✓ The company has formally established a committee of the Supervisory Board responsible for supervising the governance policies and practices of the company (e.g. Corporate Governance Committee).</li> <li>✓ The Company is publicly recognized as a national leader and among the global leaders in corporate governance.</li> </ul>

## Acknowledgements

The preparation and publication of this Manual has involved the participation and efforts of a large number of dedicated people.

This Manual was prepared in its entirety by Dr. Davit Karapetyan (Deputy Project Manager, IFC), under the supervision of Sebastian Molineus (Project Manager, IFC) and Igor Abramov (USDc, Good Governance Program Director). Chapter 13 was drafted by Tatiana Ivanova (Deputy Project Manager, IFC); Chapters 11, 15, and 16 by Leiden University's Institute of East European Law and Russian Studies (Dr. Rilka Dragneva, Associate Professor and Prof. Dr. William B. Simons, Director). Chapter 17 was drafted by Coudert Brothers LLP (Barry Metzger, Senior Partner, Derek Bloom, Partner, Dr. Kirill Ratnikov, Senior Associate, and Peter Baranovsky, Paralegal). The following people worked on or contributed to the development of earlier versions of this Manual, under the supervision of Dr. Gregory Maassen (Senior Corporate Governance Specialist,

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IFC): Dr. Davit Karapetyan (Chapters 1, 2, 8, 9, 10, 12, and 14); Igor Aksenov (Chapters 4 and 5); Polina Kalnitskaya (Chapters 3, 6, and 7); Galina Efremova (Chapter 14); and Natalya Kosheleva (Chapter 15). The following people contributed to the development of the model documents contained in the Annexes: Igor Aksenov (Annexes 6, 9, 11, 13, 14, and 26); Galina Efremova (Annexes 7, 20, 26, 28, and 29); Alexander Kaleniouk (Annex 27); Polina Kalnitskaya (Annex 3, 12, and 15); Irina Krassikova (Annexes 20, 25, and 26); and Ilya Poluyakhtov (Annexes 22 and 23).

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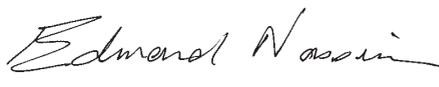
Russian by Tatyana Rybina and Olga Nikiforova (independent consultants). The translation of Annexes 3, 5, 17, 18, 24, 29, and 30 was conducted by Tatiana Govorukhina (Translator, IFC). Maria Gracheva (Editor, IFC) also played an important role, translating Annexes 4, 8, and 9, and editing the initial translations for the roundtable discussion. IFC RCGP staff also provided valuable editorial comments. The final edit of the Russian version of this Manual was conducted by Olga Nikiforova.

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Director  
Good Governance Program  
USDoC



Edward Nassim  
Director  
Central and Eastern Europe  
IFC



### Frequently Used Abbreviations and Acronyms

Annual General Meeting of Shareholders	=	AGM
Board of Directors	=	Supervisory Board or Board
Chairman of the Supervisory Board	=	Chairman
Closed Joint Stock Company	=	Closed Company
Collective Executive Body, Directorate, Management Board	=	Executive Board
Extraordinary General Meeting of Shareholders	=	EGM
Federal Commission for the Securities Market	=	FCSM
FCSM Code of Corporate Conduct	=	FCSM Code
General Meeting of Shareholders	=	GMS
Law on Joint Stock Companies	=	Company Law or LJSC
Limited Liability Company	=	LLC
Meeting of the Supervisory Board	=	Board meeting
Member of the Board of Directors	=	Supervisory Board member or director
Non-Governmental Organization	=	NGO
Open Joint Stock Company	=	Company
OECD Principles of Corporate Governance	=	OECD Principles
Sole Executive Body, Chief Executive Officer	=	General Director

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# Chapter 1

## An Introduction to **Corporate Governance**



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### **The Chairman's Checklist**

- ✓ Do all directors and key executives understand the concept of corporate governance and its significance to the company and its shareholders?
- ✓ Has the Supervisory Board developed a clear and explicit governance policy, and a plan to improve the company's governance practices? Have steps been taken to implement this plan?
- ✓ Has the company formally nominated an individual, for example the Corporate Secretary, or established a Supervisory Board committee or similar body responsible for supervising the corporate governance policies and practices of the company?
- ✓ Are key officers familiar with the Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code) and the OECD Principles of Corporate Governance? Does the company follow the main recommendations of the FCSM Code and disclose information on compliance to shareholders and stakeholders in its annual report?
- ✓ Is the company familiar with the main institutions active in the field of corporate governance that can serve as external resources for the company?

Corporate governance has become an increasingly popular term in Russia since the late 1990s. Not only has Russia witnessed a transformation in the role of the private sector in economic development and job creation, but corporate scandals, global competition, and various domestic and international efforts have made corporate governance a household name.

Unfortunately, few companies appear to truly appreciate the depth and complexity of this topic. Indeed, corporate governance reforms are often introduced superficially and used as a public relations exercise rather than as a tool to introduce the structures and process that enable the company to gain the trust of its shareholders, reduce vulnerability to financial crises, and increase the company's ability to access capital. Introducing internal structures and processes built on the principles of fairness, transparency, accountability, and responsibility is a difficult task that requires an ongoing commitment by the company.

This chapter defines corporate governance, makes a business case for its implementation, and provides an overview of the legal, regulatory, and institutional frameworks for corporate governance in Russia today.

### A. Corporate Governance Explained

#### 1. Defining Corporate Governance

There is no single definition of corporate governance that can be applied to all situations and jurisdictions. The various definitions that exist today largely depend on the institution or author, as well as country and legal tradition. For example, a regulator such as the Russian Federal Commission for the Securities Market (FCSM) is likely to define corporate governance differently than a corporate director or institutional investor.<sup>1</sup>

The International Finance Corporation and its Russia Corporate Governance Project define corporate governance as “the structures and processes for the direction and control of companies.” The Organization for Economic Cooperation and Development (OECD), which in 1999 published its Principles of Corporate Governance offers a more detailed, definition of corporate governance as

*“the internal means by which corporations are operated and controlled [...], which involve a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and*

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<sup>1</sup> The FCSM takes a broad, public sector view and its definition states that “corporate governance affects the performance of economic entities and their ability to attract the capital required for economic growth.” On the other hand, the Council of Institutional Investors, an organization of large labor and corporate pension funds whose assets exceed US\$2 trillion, takes the shareholder perspective and asserts that “in general, [...] corporate governance structures and practices should protect and enhance accountability to, and ensure the equal financial treatment of, shareholders.” (See also: [http://www.cii.org/dcwascii/web.nsf/doc/governance\\_index.cm](http://www.cii.org/dcwascii/web.nsf/doc/governance_index.cm)).

## Chapter 1. An Introduction to Corporate Governance

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*shareholders, and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.”<sup>2</sup>*

Most definitions that center on the company itself (an internal perspective) do, however, have certain elements in common, which can be summarized as follows:

- **Corporate governance is a system of relationships, defined by structures and processes:** For example, the relationship between shareholders and management consists of the former providing capital to the latter to achieve a return on their (shareholder) investment. Managers in turn are to provide shareholders with financial and operational reports on a regular basis and in a transparent manner. Shareholders also elect a supervisory body, often referred to as the Board of Directors or Supervisory Board, to represent their interests. This body essentially provides strategic direction to and control over the company’s managers. Managers are accountable to this supervisory body, which in turn is accountable to shareholders through the General Meeting of Shareholders (GMS). The structures and processes that define these relationships typically center on various performance management and reporting mechanisms.
- **These relationships may involve parties with different and sometimes contrasting interests:** Differing interests may exist between the main governing bodies of the company, i.e. the GMS, Supervisory Board and General Director (or other executive bodies). Contrasting interests exist most typically between owners and managers, and are commonly referred to as the principal-agent problem.<sup>3</sup> Conflicts may also exist within each governing body, such as between shareholders (majority vs. minority, controlling vs. non-controlling,

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<sup>2</sup> OECD Principles of Corporate Governance (see also: [www.oecd.org](http://www.oecd.org)).

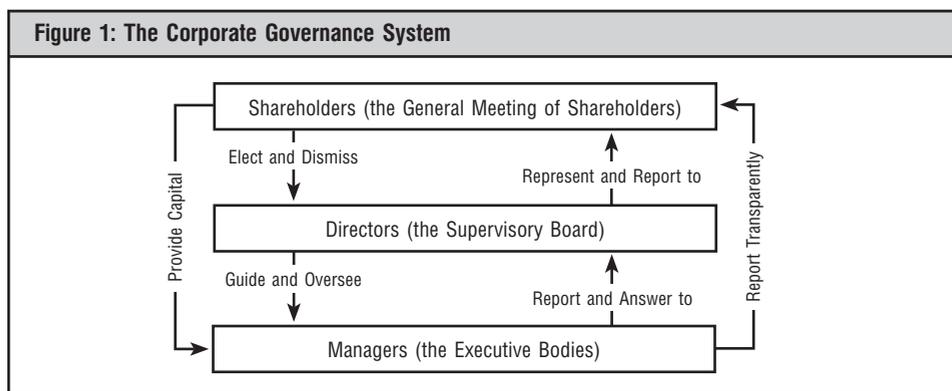
<sup>3</sup> The principal-agent problem is defined as follows by the Oxford Dictionary of Economics: “The problem of how Person (A) can motivate Person (B) to act for (A’s) benefit rather than following his self-interest.” In a company setting, Person (A) is the investor (or principal) and (B) the manager (or agent). Managers at times may follow different goals than investors (e.g. building business empires rather than creating shareholder value), act dishonestly and, at times, even in an incompetent manner. This essentially creates three types of agency costs: (i) divergence costs (i.e. managers that do not maximize the investors’ wealth); (ii) monitoring costs (investors have to develop and implement control structures), including replacement costs; and (iii) incentive costs (costs incurred by investors to remunerate and incentivize their managers). The core role of a corporate governance system is to reduce total agency costs, thus maximizing the value of the company to investors.

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individual vs. institutional) and directors (executive vs. non-executive, outside vs. inside, independent vs. dependent); and each of these contrasting interests needs to be carefully observed and balanced.

- **All parties are involved in the direction and control of the company:** The GMS, representing shareholders, takes fundamental decisions, for example the distribution of profits and losses. The Supervisory Board is generally responsible for guidance and oversight, setting company strategy and controlling managers. Executives, finally, run the day-to-day operations, such as implementing strategy, drafting business plans, managing human resources, developing marketing and sales strategies, and managing assets.
- **All this is done to properly distribute rights and responsibilities — and thus increase long-term shareholder value.** For example, how can outside, minority shareholders prevent a controlling shareholder from gaining benefits through related party transactions, tunneling, or similar means.<sup>4</sup>

The basic corporate governance system and the relationships between the governing bodies are depicted in Figure 1.



Source: IFC, March 2004

The external aspect of corporate governance, on the other hand, concentrates on relationships between the company and its stakeholders. Stakeholders are those individuals or institutions that have an interest in the enterprise; such an interest

<sup>4</sup> Corporate Governance: A Framework for Implementation, the World Bank. See also: <http://www.worldbank.org/html/fpd/privatesector/cg/docs/gcgfb booklet.pdf>.

may arise through legislation or contract, or by way of social or geographic relationships. Stakeholders include investors, but also employees, creditors, suppliers, consumers, regulatory bodies and state agencies, and the local community in which a company operates. Some commentators also include consideration of the environment as an important entry on the list of stakeholders.

### 2. The Role of Stakeholders

Many international codes, including the OECD Principles, discuss the role of stakeholders in the governance process. The role of stakeholders in governance has been debated in the past, with some arguing that stakeholders have no claim on the enterprise other than those specifically set forth in law or contract. Others have argued that companies fulfill an important social function, have a societal impact and must, accordingly, act in the broad interests of society. This view recognizes that companies should, at times, act at the expense of shareholders.

Interestingly, there is a consensus that modern companies cannot effectively conduct their businesses while ignoring the concerns of stakeholder groups. However, there is also an agreement that companies which consistently place other stakeholder interests before those of shareholders cannot remain competitive over the long run.

**Best Practices:** A key aspect of corporate governance is concerned with ensuring the flow of external capital to firms. Corporate governance is also concerned with finding ways to encourage stakeholders to undertake socially efficient levels of investment in firm-specific human and physical capital. The competitiveness and ultimate success of a corporation is the result of teamwork that embodies contributions from a range of resource providers including investors, employees, creditors, and suppliers. Corporations should recognize that the contributions of stakeholders constitute a valuable resource for building competitive and profitable companies. It is, therefore, in the long-term interest of corporations to foster wealth-creating co-operation among stakeholders. The governance framework should acknowledge that the interests of the corporation are served by recognizing the interests of stakeholders and their contribution to the long-term success of the corporation.<sup>5</sup>

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<sup>5</sup> OECD Principles of Corporate Governance, Annotations to Principle III on the Role of Stakeholders in Corporate Governance. See also: [www.oecd.org](http://www.oecd.org).

The degree to which stakeholders participate in corporate governance largely depends on national laws and practices, and may vary from country to country. Employee representation on the Supervisory Board is one example of such stakeholder participation mechanisms; governance processes that consider stakeholder viewpoints for certain key decisions is another.

In any event, directors and managers will want to give due consideration to this complex issue and to the stakeholders' role in the governance of the company.

### 3. A Brief History

Corporate governance systems have evolved over centuries, often in response to corporate failures or systemic crises. The first well-documented failure of governance was the South Sea Bubble in the 1700s, which revolutionized business laws and practices in England. Similarly, much of the securities law in the U.S. was put in place following the stock market crash of 1929. There has been no shortage of other crises, such as the secondary banking crisis of the 1970s in the U.K., U.S. savings and loan debacle of the 1980s, and, closer to home, the 1998 financial crisis in Russia.

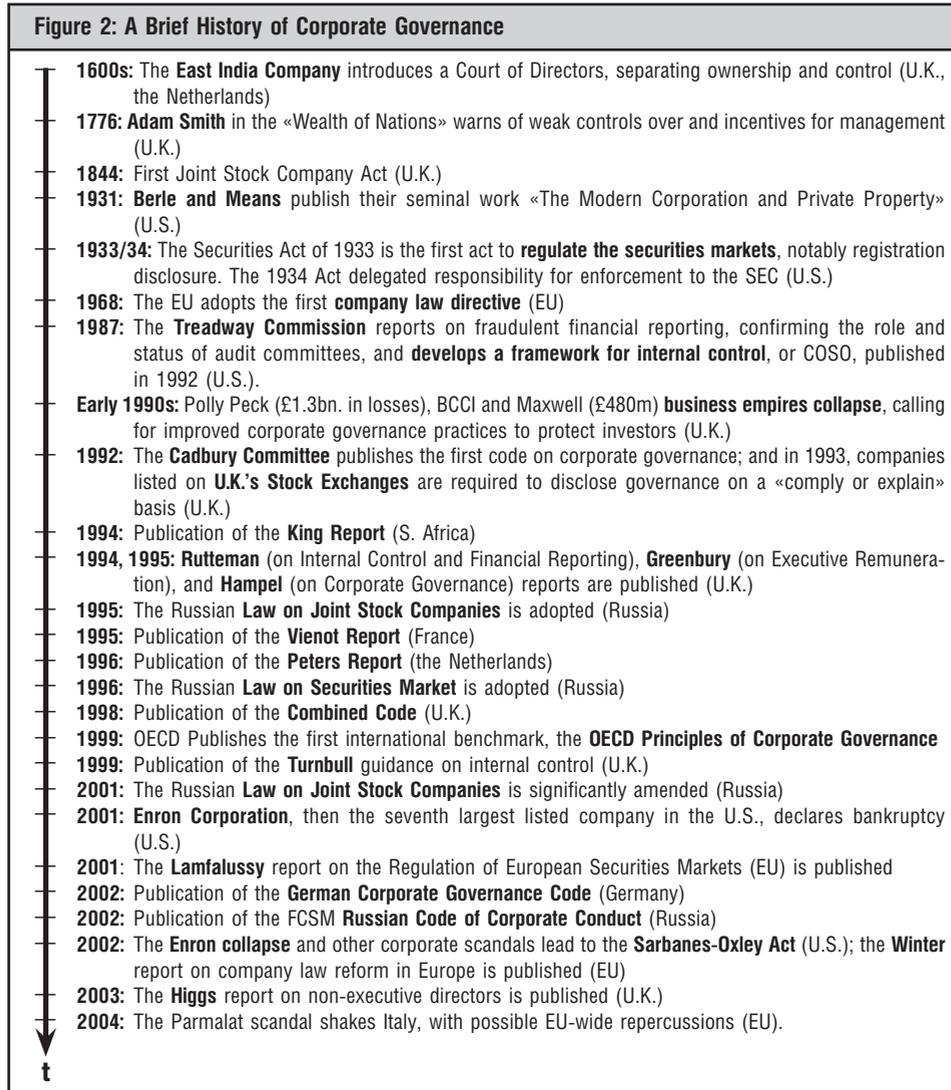
The history of corporate governance has also been punctuated by a series of well-known company failures. The early 1990s saw the Maxwell Group raid the pension fund of the Mirror Group of newspapers and witnessed the collapse of Bearings Bank. The new century likewise opened with a bang, with the spectacular collapse of Enron in the U.S., the near-bankruptcy of Vivendi Universal in France, and the recent scandal at Parmalat in Italy. Each of these corporate failures — often occurring as a result of incompetence or outright fraud — was swiftly met by new governance frameworks, most notably the many national corporate governance codes and the Sarbanes-Oxley Act.

In Russia too, much has changed since the rampant asset stripping and transfer pricing abuses that took place during the early days of transition, not to mention the abuses that took place during Russia's two privatization phases. The 1998 financial crisis perhaps brought the harshest response. However, the legal and regulatory framework has improved dramatically in recent years. The adoption of the Company Law in 1995 and its subsequent update in 2001, together with the adoption of amendments to the Law on the Securities Market in 2002, are but two examples of the many positive changes to the legal and regulatory framework. The publication of the FCSM Code certainly must be hailed as a landmark for

## Chapter 1. An Introduction to Corporate Governance

Russian corporate governance, providing the first ever benchmark on this subject for Russian companies.

Figure 2 illustrates some highlights in the history of corporate governance, largely from the western world.



Source: IFC, March 2004

### 4. The International Scope of Corporate Governance

Numerous codes of best practices and corporate governance principles have been developed over the last ten years. Worldwide, over 100 codes have been written in some 40 countries and regions.<sup>6</sup> Most of these codes focus on the role of the Supervisory Board (or Board of Directors) in the company. A handful are international in scope.<sup>7</sup>

Among these, only the OECD Principles address both policy makers and businesses, and focus on the entire governance framework (shareholder rights, stakeholders, disclosure, and board practices). The OECD Principles have gained worldwide acceptance as a framework and reference point for corporate governance. Published in 1999 and revised in 2004, they were developed to provide principle-based guidance on good governance.

The OECD corporate governance framework is built on four core values:

- **Fairness:** The corporate governance framework should protect shareholder rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violations of their rights.
- **Responsibility:** The corporate governance framework should recognize the rights of stakeholders as established by law, and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
- **Transparency:** The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the company, including its financial situation, performance, ownership, and governance structure.

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<sup>6</sup> For a complete list of country codes of corporate governance, see the website of the European Corporate Governance Institute under [www.ecgi.com](http://www.ecgi.com).

<sup>7</sup> Corporate governance codes of international scope include the OECD Principles of Corporate Governance ([www.oecd.org](http://www.oecd.org)), recommendations of the European Association of Securities Dealers (EASD — [www.easd.com](http://www.easd.com)), the Corporate Governance Guidelines of the Confederation of European Shareholders Associations ([www.wfic.org/esh](http://www.wfic.org/esh)), the International Corporate Governance Network's Statement on Global Corporate Governance Principles (ICGN — [www.icgn.org](http://www.icgn.org)), and the Commonwealth Association for Corporate Governance (CACG — [www.cacg-inc.com](http://www.cacg-inc.com)).

- **Accountability:** The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and shareholders.

Many national codes of governance, including the FCSM Code, have been developed based on the OECD Principles. The OECD Principles can serve as an excellent reference point for international practice and are recommended reading for those interested in understanding some of the principles that underlie national standards.

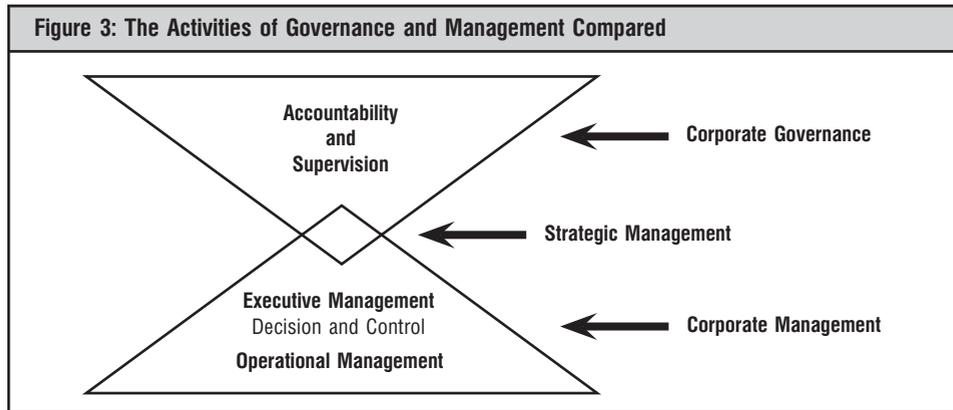
**Best Practices:** The FCSM Code states that: "The principles of corporate conduct set forth in this chapter form the basis of the recommendations contained in the chapters of this Code that follow, and also serve as fundamental guidelines to be observed in the absence of specific recommendations. These principles have been drafted according to the OECD's Principles of Corporate Governance, international [...] practice, as well as experience accumulated in Russia since the enactment of the Federal Law On Joint Stock Companies."<sup>8</sup>

### 5. Distinguishing Corporate Governance

Corporate governance must not be confused with corporate management. Corporate governance focuses on a company's structure and processes to ensure fair, responsible, transparent, and accountable corporate behavior. Corporate management on the other hand focuses on the tools required to operate the business. Corporate governance is situated at a higher level of direction that ensures that the company is managed in the interest of its shareholders. One area of overlap is strategy, which is dealt with at the corporate management level and is also a key corporate governance element. Figure 3 illustrates the difference between corporate governance and corporate management.

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<sup>8</sup> FCSM Code, Chapter 1, Introduction.



Source: Robert I. Tricker, *Corporate Governance*, 1984

Corporate Governance must also not be confused with public governance, which deals with the governance structures and systems within the public sector.

Corporate governance must further be distinguished from good corporate citizenship, corporate social responsibility, and business ethics. Good corporate governance will certainly reinforce these important concepts. But while companies that do not pollute and invest in socially responsible projects or run charitable foundations often benefit with superior reputation, public goodwill, and even better profitability, corporate governance is and remains distinct from these concepts.

## B. The Business Case for Corporate Governance

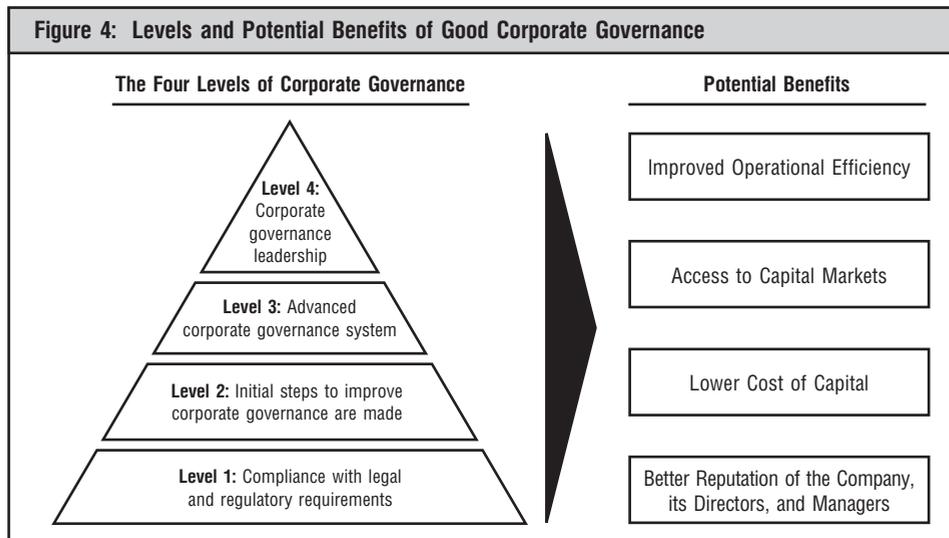
Good corporate governance is important on a number of different levels.

At the company level, well-governed companies tend to have better and cheaper access to capital, and tend to outperform their poorly governed peers over the long-term. Companies that insist upon the highest standards of governance reduce many of the risks inherent to an investment in a company. Companies that actively promote robust corporate governance practices need key employees who are willing and able to devise and implement good corporate governance policies. These companies will generally value and compensate such employees more than their competitors that are unaware of, or ignore, the benefits of these

policies and practices. In turn, such companies tend to attract more investors who are willing to provide capital at lower cost.

More generally, well-governed companies are better contributors to the national economy and society. They tend to be healthier companies that add more value to shareholders, workers, communities, and countries in contrast with poorly governed companies that may cause job losses, the loss of pensions, and even undermine confidence in securities markets.

Some of the building blocks, or levels, and specific benefits of good governance are depicted in Figure 4 and discussed in further detail below.

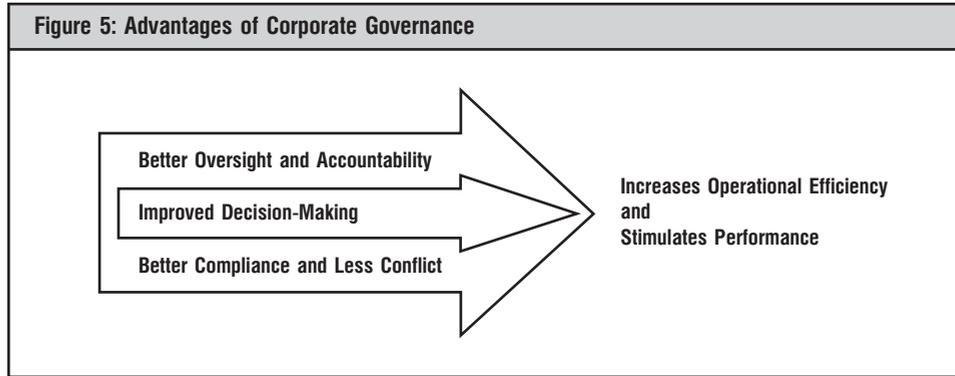


Source: IFC, March 2004

→ See also the IFC corporate governance progression matrix in Part VI, Annex 1.

### 1. Stimulating Performance and Improving Operational Efficiency

There are several ways in which good corporate governance can improve performance and operational efficiency, as illustrated in Figure 5.



Source: IFC, March 2004

Improvement in the company's governance practices leads to an improvement in the accountability system, minimizing the risk of fraud or self-dealing by the company's officers. Accountable behavior, combined with effective risk management and internal controls, can bring potential problems to the forefront before a full-blown crisis occurs. Corporate governance improves the management and oversight of executive performance, for example by linking executive remuneration to the company's financial results. This creates favorable conditions not only for planning the smooth succession and continuity of the company's executives, but also for sustaining the company's long-term development.

Adherence to good corporate governance standards also helps to improve the decision-making process. For example, managers, directors and shareholders are all likely to make more informed, quicker and better decisions when the company's governance structure allows them to clearly understand their respective roles and responsibilities, as well as when communication processes are regulated in an effective manner. This, in turn, should significantly enhance the efficiency of the financial and business operations of the company at all levels. High quality corporate governance streamlines all the company's business processes, and this leads to better operating performance and lower capital expenditures,<sup>9</sup> which, in turn,

<sup>9</sup> Paul A. Gompers, Joy L. Ishii and Andrew Metrick, Corporate Governance and Equity Prices, NBER Working Paper No. w8449, August 2001.

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may contribute to the growth of sales and profits with a simultaneous decrease in capital expenditures and requirements.

An effective system of governance practices should ensure compliance with applicable laws, standards, rules, rights, and duties of all interested parties, and further, should allow companies to avoid costly litigation, including those costs related to shareholder claims and other disputes resulting from fraud, conflicts of interest, corruption and bribery, and insider trading. A good system of corporate governance will facilitate the resolution of corporate conflicts between minority and controlling shareholders, executives and shareholders, and between shareholders and stakeholders. Also, company officers will be able to minimize the risk of personal liability.

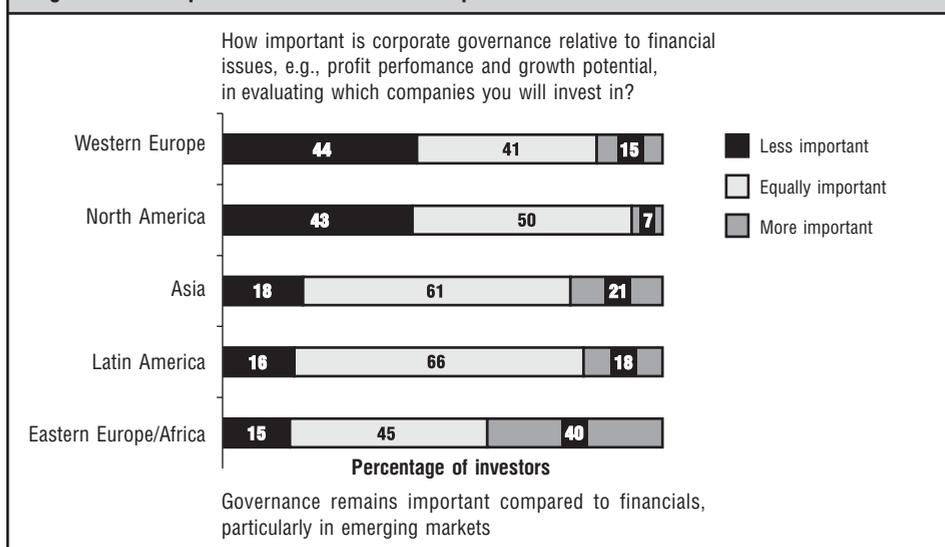
### 2. Improving Access to Capital Markets

Corporate governance practices can determine the ease with which companies are able to access capital markets. Well-governed firms are perceived as investor-friendly, providing greater confidence in their ability to generate returns without violating shareholder rights.

Good corporate governance is based on the principles of transparency, accessibility, efficiency, timeliness, completeness, and accuracy of information at all levels. With the enhancement of transparency in a company, investors benefit from being provided with an opportunity to gain insight into the company's business operations and financial data. Even if the information disclosed by the company is negative, shareholders will benefit from the decreased risk of uncertainty.

Of particular note is the observable, if recent trend among investors to include corporate governance practices as a key decision-making criterion in investment decisions. The better the corporate governance structure and practices, the more likely that assets are being used in the interest of shareholders and not being tunneled or otherwise misused by managers. Figure 6 illustrates that corporate governance practices can take on particular importance in emerging markets where shareholders do not always benefit from the same protections as are available in more developed markets.

**Figure 6: The Importance of Governance Compared to Financial Statements**



Source: McKinsey & Company, Global Investor Opinion Survey, July 2002

Finally, new listing requirements on many stock exchanges around the world require companies to adhere to increasingly strict standards of governance. Companies wishing to access both domestic and international capital markets will need to adhere to specific corporate governance standards.

### 3. Lowering the Company's Cost of Capital and Raising the Value of Assets

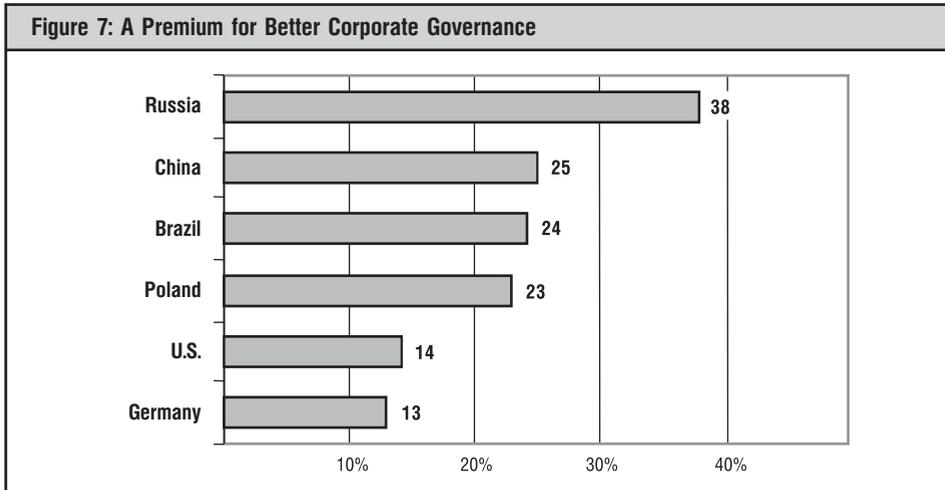
Companies committed to high standards of corporate governance are typically successful in obtaining reduced costs when incurring debt and financing for operations, and in this way, they are able to decrease their cost of capital. The cost of capital depends upon the level of risk assigned to the company by investors: the higher the risk, the higher the cost of capital. These risks include the risk of violations of investor rights. If investor rights are adequately protected, the cost of equity and debt capital may decrease. It should be noted that investors providing debt capital, i.e. creditors, have recently tended to include a company's corporate governance practices (for example transparent ownership structure and appropriate financial reporting) as a key criterion in their investment decision-making process. Thus, the implementation of a good corporate governance system

## Chapter 1. An Introduction to Corporate Governance

should ultimately result in the company paying lower interest rates and receiving longer maturity on loans and credits.

The level of risk and cost of capital also depend on a country's economic or political situation, institutional framework, and enforcement mechanisms. Corporate governance at a particular company thus plays a crucial role in emerging markets, which often do not have as good a system of enforcing investor rights as countries with developed market economies.

This holds particularly true in countries such as Russia where the legal framework is relatively new and still being tested, and where courts do not always provide investors with effective recourse when their rights are violated. This means that even modest improvements in corporate governance relative to other companies can make a large difference for investors and decrease the cost of capital.<sup>10</sup> Figure 7 tellingly demonstrates that a majority of investors are willing to pay a premium for a well-governed company; this premium amounts to 38% for Russian companies. At the country level, studies show that Russia has considerably higher borrowing costs than many other countries due to corruption, opaque legislation and judicial practices, weak corporate governance, uncertainty, and arbitrariness.<sup>11</sup>



Source: McKinsey & Company, Global Investor Opinion Survey, July 2002

<sup>10</sup> Leora F. Klapper, Inessa Love, Corporate Governance, Investor Protection and Performance in Emerging Markets, World Bank Policy Research Working Paper 2818, April 2002.

<sup>11</sup> The Opacity Index, PricewaterhouseCoopers, January 2001 (<http://www.opacity-index.com>).

At the same time, there is a strong relationship between governance practices and how investors perceive the value of company assets (such as fixed assets, receivables, product portfolio, human capital, research and development, and goodwill).

### **4. Building a Better Reputation**

In today's business environment, reputation has become a key element of a company's goodwill. A company's reputation and image effectively constitute an integral, if intangible, part of its assets. Good corporate governance practices contribute to and improve a company's reputation. Thus, those companies that respect the rights of shareholders and creditors, and ensure financial transparency and accountability, will be regarded as being an ardent advocate of investors' interests. As a result, such companies will enjoy more public confidence and goodwill.

This public confidence and goodwill can lead to higher trust in the company and its products, which in turn may lead to higher sales and, ultimately, profits. A company's positive image or goodwill is moreover known to play a significant role in the valuation of a company. Goodwill in accounting terms is the amount that the purchase price exceeds the fair value of the acquired company's assets. It is the premium one company pays to buy another.

### **C. The Cost of Corporate Governance**

Good governance entails real costs. Some of the costs include hiring dedicated staff such as corporate secretaries, experienced and independent directors, internal auditors, or other governance specialists. It will likely require the payment of fees to external counsel, auditors, and consultants. The costs of additional disclosure can be significant as well. Furthermore, it requires considerable managerial and Supervisory Board time, especially in the start-up phase. These costs tend to make implementation considerably easier for larger companies that may have the resources to spare than smaller companies whose resources may be stretched quite thin.

**Best Practices:** Corporate governance is most, if not solely, applicable to larger, open joint stock companies that are publicly traded on an exchange. A large, dispersed shareholder base, where controlling shareholders and managers can wield extraordinary powers and potentially abuse shareholder rights, often defines such companies. Large companies are moreover important elements of a country's economy and thus require close public scrutiny and attention. This holds particularly true in Russia, where the 23 largest business groups control 35% of the country's industry by sales (RUR 1.7 trillion or approximately U.S. \$ 60 billion) and at least 16% of its employment (1.44 million people).<sup>12</sup> Moreover, the 42 largest companies by market capitalization make up 98% of the total value of all listed companies in Russia;<sup>13</sup> and of these, three alone (RAO UES, Gazprom and MPS) make-up 13.5% of Russia's GDP.

Notwithstanding, corporate governance is beneficial to all companies, irrespective of size, legal form, number of shareholders, ownership structure or other characteristics. Of course, a one-size-fits-all approach should be avoided and companies should carefully apply corporate governance standards. For example, smaller companies may not require a full set of Supervisory Board committees or a full-time Corporate Secretary. On the other hand, even a small company may benefit from an advisory body.

A company will not always see instant improvements to its performance due to better corporate governance practices. However, returns, while sometimes difficult to quantify, generally exceed the costs in particular over the long term. This is especially true when one takes into account potential risks of losses in jobs, pensions, invested capital and the disruption that may be caused to communities when companies collapse. In some cases, systemic governance problems may undermine faith in the financial markets and threaten market stability.

Finally, it must be noted that corporate governance is not a one-time exercise but rather an ongoing process. No matter how many corporate governance structures and processes the company has in place, it is advisable to regularly update and review them. Markets tend to value long-term commitment to good governance practice rather than a single action or "box-ticking" exercises.

<sup>12</sup> The World Bank, From Transition To Development, A Country Economic Memorandum for the Russian Federation, April 2004.

<sup>13</sup> Standard & Poor's, Concentration of Ownership and Corporate Governance in Russia – What Drives the Trend? EuroWeek, March 2003.

### D. The Corporate Governance Framework in Russia

#### 1. Specifics of Corporate Governance in Russia

While many argue that corporate governance models are converging, important differences remain. All countries have a unique history, culture, and legal and regulatory framework, each of which influences a company's corporate governance framework. The following is a list of features that characterize Russia's corporate sector.

*Concentrated ownership.* Although the early 1990s witnessed a relatively dispersed ownership structure in the follow-up to the privatization phase — if only briefly and formally — most Russian companies today are controlled by a single controlling shareholder or small group of shareholders. This holds true not only for the natural resource sector, such as oil production and processing, but communications, metallurgy and forestry as well. This concentrated ownership structure often results in minority shareholder abuses. Insider dominance and the weak protection of external shareholders/investors has largely contributed to the underdevelopment of the capital markets in Russia; to date, there are only a handful of companies listed on Russia's two major stock exchanges.<sup>14</sup> A trend, albeit nascent, towards IPOs and thus more dispersed ownership can however be witnessed. Whether these majority shareholders are truly willing to reduce or even exit their investments, remains to be seen.

*Little separation of ownership and control.* Most controlling shareholders also act as the company's General Director and sit on the Supervisory Board. Those companies that do separate ownership and control often do so only on paper. Such companies typically suffer from weak accountability and control structures (effectively, the majority/controlling shareholders oversee themselves in their function as directors and managers), abusive related party transactions, and poor information disclosure (insiders have access to all information and are unmotivated to disclose to outsiders).

*Unwieldy holding structures.* Major business groups in the form of holding companies control companies in most industries. While holding structures can serve legitimate purposes, complex business structures, cross-shareholdings, pyra-

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<sup>14</sup> As of February 2004, there are eight companies listed on Tier A, Level 1, 14 companies on Tier A, Level 2, and 16 companies on Tier B on the RTS stock exchange.

mid structures, and other arrangements to create opaque ownership structures can make the company difficult to understand for shareholders and investors. Such structures are often used to expropriate and circumvent the rights of individual shareholders. Poor consolidated accounting, or even the absence thereof, is a further corporate governance issue that has yet to be tackled.

*Reorganization.* On the other hand, many of these holding structures are currently being reorganized for various reasons. Some controlling shareholders have discovered a desire to build and run proper businesses — based on good corporate governance — thus leaving a positive legacy behind. Others seek to properly transfer their businesses to the next generation or sell their stakes to outside investors. This process may still take place outside the legal system and is often marked by conflicts, although many of the criminal takeovers that marked the 1990s have subsided.

*Inexperienced and inadequate Supervisory Boards.* The concept of supervisory bodies was only introduced with Russia's transition to a market economy. Such a supervisory structure did not exist in state-owned enterprises during the Soviet Union. General Directors often seek to bypass this supervisory structure, seeking direct contact with the controlling shareholder (in as much as they are not one and the same person). The role of Supervisory Boards often remains unclear, with some taking on authorities that belong to the GMS and others becoming actively involved in the company's day-to-day management. Strong, vigilant and independent Supervisory Boards remain a rarity.

## 2. The Legal and Regulatory Framework

Russia's legal and regulatory framework for corporate governance has improved dramatically but remains nascent. The first comprehensive piece of legislation was approved in late 1995 when the Law on Joint Stock Companies was adopted. By that time, however, many companies had already been created, most in the wake of the first phase of privatization, and a proper corporate governance structure to guide companies was largely absent.

Today, all commercial enterprises, regardless of their legal form, are subject to a comprehensive set of laws, regulations, and governmental decrees as illustrated in Figure 8. In addition to the general legal and regulatory framework, there are legal acts that deal in more detail with specific corporate forms in Russia such as joint stock or limited liability companies.

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**Figure 8: Principal Laws and Regulations Impacting Corporate Governance**

Law / Regulation	Applicability	Comments
<b>Civil Code</b>	All commercial entities	Regulates basic governance framework
<b>Company Law</b>	Joint Stock Companies (JSCs)	Regulates founding, operation, and liquidation/reorganization of JSCs
<b>Securities Law</b>	JSCs that have publicly issued securities	Regulates procedures of issuance and circulation of securities; information disclosure
<b>FCSM Regulations</b>	JSCs that have publicly issued securities	Expands upon the Company and Securities Law
<b>Secondary Regulations (tax, bankruptcy, etc.)</b>	All commercial entities	Regulates specific issues for commercial entities
<b>Listing Requirements</b>	JSCs listed on a stock exchange	Regulates access to trading for issuers and investors

Source: IFC, March 2004

For example, the Civil Code and the Company Law apply to all joint stock companies in Russia.<sup>15</sup> In addition to this general rule, companies in the banking, investment and insurance industries, as well as agribusinesses and state- or municipally-owned companies, need to comply with specific legislation.<sup>16</sup> Securities legislation (the Law on the Securities Market) and regulations by the FCSM also apply to publicly traded companies.

Russian companies are also subject to other laws including, among others, laws on taxation, the registration of legal entities, bankruptcy, accounting, and auditing. Where appropriate, this Manual refers to these and other legal acts.

The list of legal acts in Figure 8 is far from complete. Moreover, Russian legislation continues to change as it develops and improves. For example, the Company Law has been amended several times in order to eliminate inconsisten-

<sup>15</sup> Law on Joint Stock Companies (LJSC), Article 1, Clause 2.

<sup>16</sup> LJSC, Article 1, Clauses 3–5.

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cies in provisions that regulate the activities of governing bodies, securities issues, the exercise of shareholder rights, and other matters.

Finally, Russian companies are being encouraged to adhere to voluntary codes of corporate governance such as the FCSM Code through listing requirements.

**Best Practices:** The corporate governance framework typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments, and business practices that are the result of country specific circumstances, history, and tradition. The desirable mix between legislation, regulation, self-regulation, voluntary standards, etc. in this area will therefore vary from country to country. As new experiences accrue and business circumstances change, the content and structure of this framework needs to be adjusted.<sup>17</sup> Companies will need to carefully monitor such adjustments on a regular basis, and update their governance systems accordingly.

### 3. The Federal Commission for the Securities Market's Code of Corporate Conduct

The FCSM Code was presented to the private sector in April 2002 and draws upon generally accepted principles of corporate governance, including the OECD Principles.

**Best Practices:** Good corporate governance practices are focused on respect for the lawful interests of all participants in corporate activities. They can improve the quality of a company's operations by means of, among other things, increasing the value of corporate assets, creating jobs and enhancing the financial stability and profitability of the company. Trust among all those involved in corporate activities is at the root of the effective operation of a company and the ability to attract investment. The Principles of Corporate Governance [...] are aimed at the creation of trust in relations arising in connection with corporate governance.<sup>18</sup>

<sup>17</sup> OECD Principles of Corporate Governance, Annotations to the OECD Principles of Corporate Governance, Ensuring an effective corporate governance framework. See also: [www.oecd.org](http://www.oecd.org).

<sup>18</sup> FCSM Code, Chapter 1, Introduction.

While the FCSM Code is voluntary, there is some “force” behind its recommendations. Recently the FCSM issued a “methodological recommendation” to enforce compliance with its Code by publicly listed companies on a “comply” instead of “comply-or-explain basis.”<sup>19</sup> This “methodological recommendation” deviates from standard disclosure practices found on most western exchanges, which require companies to disclose on a “comply-or-explain basis”, allowing them to deviate from certain recommendations that may not be applicable. Russian stock exchanges have since amended their listing requirements. More specifically, the Moscow Interbank Currency Exchange (MICEX) now requires that companies listed on Tier-A, Level 1 confirm their compliance with all recommendations contained in the FCSM Code.<sup>20</sup> On the same exchange, companies listed on Tier A, Level 2 are only required to comply with the recommendations contained in Chapter 7 of the FCSM Code on information disclosure.<sup>21</sup> Similar rules on both levels are stipulated for listing securities on the RTS stock exchange.<sup>22</sup>

**Best Practices:** The following principles of corporate conduct are fundamental guidelines underlying the formation, operation, and enhancement of a company’s system of corporate governance:<sup>23</sup>

1. Corporate practice should provide shareholders with a real opportunity to exercise their rights in relation to the company.
2. Corporate governance practice should provide for the equitable treatment of all shareholders. Shareholders should have access to effective recourse in the event of a violation of their rights.
3. Corporate governance practice should provide for the direction and control by the Supervisory Board of the executive bodies of the company, and for the accountability of the Supervisory Board to shareholders.

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<sup>19</sup> FCSM Instruction No. 03-1169/r on the Approval of Methodological Recommendations for the Exercise of Control by the Organizers of Trade on Securities Market over the Compliance by Joint Stock Companies with the Provisions of the Code of Corporate Conduct, 18 June 2003, Section 2. Russia’s two leading stock exchanges are MICEX and RTS.

<sup>20</sup> Annex 1d, Rules of Listing, Access to Placement and Trade on the Moscow Interbank Currency Exchange, Section 9.

<sup>21</sup> Annex 1d, Rules of Listing, Access to Placement and Trade on the Moscow Interbank Currency Exchange, Section 10.

<sup>22</sup> Rules for the Access to Circulation of Securities, RTS stock exchange, Articles 5.2.6 and 5.3.4.

<sup>23</sup> FCSM Code, Chapter 1, Sections 1–7.

4. Corporate governance practice should ensure that executive bodies manage the day-to-day activities of the company without undue interference, in good faith, and solely in the interests of the company, and ensure that executive bodies report in full and on a timely basis to the Supervisory Board and shareholders.
5. Corporate governance practice should, in particular, provide for the full, timely, and accurate disclosure of all material information (including information about a company's financial position, financial indicators, and ownership and management structure) in order to enable shareholders and investors to make informed decisions.
6. Corporate governance practice should ensure compliance with applicable laws as related to the statutory or contractual rights of all stakeholders. Corporate governance practice should, more generally, encourage the consideration of the interests of stakeholders, including employees, even when they are not expressly set forth in law, and support active cooperation between the company and stakeholders with a view to increasing the assets and value of the company, and to creating new jobs.
7. Corporate governance practice should provide for the effective control over the financial and business operations of the company to protect the rights and lawful interests of shareholders.

### 4. The Institutional Framework

There are numerous institutions that make-up the institutional framework for corporate governance in Russia today, too many to list exhaustively. The following institutions have at least one core activity focusing on corporate governance.

<b>Courts</b>	
The Supreme Arbitration Court	<a href="http://www.arbitr.ru">www.arbitr.ru</a>
<b>Public Sector Institutions</b>	
Federal Service for the Financial Markets	<a href="http://www.fcsfm.ru">www.fcsfm.ru</a>
Ministry of Economic Development and Trade	<a href="http://www.economy.gov.ru">www.economy.gov.ru</a>
State Duma	<a href="http://www.duma.gov.ru">www.duma.gov.ru</a>

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<b>Table 1: Corporate Governance Related Institutions in Russia</b>	
<b>Private Sector Institutions and Market Participants</b>	
MICEX	<a href="http://www.micex.ru">www.micex.ru</a>
RTS	<a href="http://www.rts.ru">www.rts.ru</a>
Standard & Poor's	<a href="http://www.standardandpoors.ru">www.standardandpoors.ru</a>
Troika Dialog	<a href="http://www.troika.ru">www.troika.ru</a>
<b>NGOs</b>	
Association of Managers	<a href="http://www.amr.ru">www.amr.ru</a>
Association of Russian Banks	<a href="http://www.arb.ru">www.arb.ru</a>
Chamber of Commerce and Industry	<a href="http://www.tpprf.ru">www.tpprf.ru</a>
Guild of Investment and Financial Analysts	<a href="http://www.gifa.ru">www.gifa.ru</a>
Independent Directors Association	<a href="http://www.naid.ru">www.naid.ru</a>
Institute of Corporate Law and Governance	<a href="http://www.iclg.ru">www.iclg.ru</a>
Institute of Internal Auditors	<a href="http://www.iaa-ru.ru">www.iaa-ru.ru</a>
Institute of Professional Auditors	<a href="http://www.e-ipar.ru">www.e-ipar.ru</a>
Institute of Professional Directors	<a href="http://www.fipd.ru">www.fipd.ru</a>
Investor Protection Association	<a href="http://www.corp-gov.ru">www.corp-gov.ru</a>
Moscow Chamber of Commerce and Industry	<a href="http://www.mtpp.org">www.mtpp.org</a>
National Association of Stock Market Participants	<a href="http://www.naufor.ru">www.naufor.ru</a>
Professional Association of Registrars, Transfer Agents, and Depositaries (PARTAD)	<a href="http://www.partad.ru">www.partad.ru</a>
Russian Institute of Directors	<a href="http://www.rid.ru">www.rid.ru</a>
Russian Institute of Stock Market and Management	<a href="http://www.ismm.ru">www.ismm.ru</a>
Russian Union of Industrialists and Entrepreneurs	<a href="http://www.rsppr.ru">www.rsppr.ru</a>
<b>International Organizations</b>	
Global Corporate Governance Forum (GCGF)	<a href="http://www.gcgf.org">www.gcgf.org</a>
International Finance Corporation (IFC)	<a href="http://www.ifc.org">www.ifc.org</a>
Organization for Economic Cooperation and Development (OECD)	<a href="http://www.oecd.org">www.oecd.org</a>
The World Bank	<a href="http://www.worldbank.org">www.worldbank.org</a>
<b>Universities</b>	
Higher School of Economics – Center for Corporate Governance	<a href="http://www.hse.ru">www.hse.ru</a>



# Chapter 2

## The **General Governance Structure** of a Company

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## **The Chairman's Checklist**

- ✓ Does the company's legal form best reflect the interests of the owners? Are other forms better suited to advance such interests? What are the advantages and disadvantages of the alternatives?
- ✓ In addition to the General Meeting of Shareholders, Supervisory Board and Revision Commission, has the company established an Executive Board, Supervisory Board committees, and an Internal Audit Function (Control and Revision Service)? Have these bodies been given the appropriate structures and proper resources to be effective? Does the company have a Corporate Secretary?

Company Law defines a joint stock company's status and provides for the structure of its governing bodies. The Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code) further includes recommendations to establish additional governing bodies, for example Supervisory Board committees, the Corporate Secretary, and the Control and Revision Service. This chapter discusses the concept and governance structure of companies as they are defined by the Company Law and as recommended by the FCSM Code. The authorities, functions, and structures of the governing bodies are described in more detail in other chapters of this Manual.

## **A. What Is a Joint Stock Company?**

### **1. The Definition of a Company**

The Civil Code<sup>24</sup> and the Company Law<sup>25</sup> define a company as:

- A commercial entity,
- Whose charter capital is divided into a specified number of shares,
- Certifying the company participants' (shareholders') rights in relation to the company.

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<sup>24</sup> Civil Code (CC), Article 96, Clause 1.

<sup>25</sup> Law on Joint Stock Companies (LJSC), Article 2, Clause 1, Paragraph 1.

Companies are the only legal entities that can issue shares. The shareholders are normally not liable for the company's obligations. Their risk is limited to the loss of the value of the shares they hold in the company.<sup>26</sup>

### 2. Open and Closed Joint Stock Companies

Legislation distinguishes between open and closed joint stock companies.<sup>27</sup> Open companies require higher charter capital, and are subject to stricter and more complex rules regarding their governance and disclosure. Closed companies may be better suited for smaller enterprises for which a simple structure is usually preferable. Open companies are generally better suited for larger and growing companies that might wish to raise money in the equities markets.

	<b>Open Companies</b>	<b>Closed Companies</b>
<b>Number of Shareholders</b> <sup>28</sup>	No limit.	Maximum of 50.
<b>Minimum Charter Capital</b> <sup>29</sup>	1,000 times the minimum wage on the date of registration.	100 times the minimum wage on the date of registration.
<b>Issuance of Shares</b> <sup>30</sup>	Open subscription. A closed subscription is permitted unless the charter or legislation provides otherwise.	Closed subscription (only among founders or other pre-determined groups of persons). Cannot issue shares through an open subscription.
<b>Transferability of Shares</b> <sup>31</sup>	No restrictions. Neither the consent of other shareholders nor the company is required.	Restricted. Other shareholders (and the company, if specified by the charter) have a right of first refusal.

<sup>26</sup> LJC, Article 2, Clause 1; CC, Article 96, Clause 1.

<sup>27</sup> LJC, Article 7, Clause 1.

<sup>28</sup> LJC, Article 7, Clauses 2 and 3.

<sup>29</sup> LJC, Article 26. The Law on the Minimum Amount of Payment for Labor (minimum wage) of 2 June 2000, Article 4. As of 1 September 2003, the minimum charter capital of an open company is 1,000 times RUR 100 (RUR 100,000), for a closed company 100 times RUR 100 (RUR 10,000).

<sup>30</sup> LJC, Article 7, Clauses 2 and 3.

<sup>31</sup> LJC, Article 7, Clauses 2 and 3.

## Chapter 2. The General Governance Structure of a Company

	<b>Open Companies</b>	<b>Closed Companies</b>
<b>Supervisory Board</b> <sup>32</sup>	Mandatory for an open company with 50 or more shareholders with voting rights.	Voluntary.
<b>Disclosure</b> <sup>33</sup>	The company must disclose a wide range of information regarding its financial position and operations.	The company must disclose certain information if it issues bonds or other securities to the public. Otherwise, no legal requirements to publicly disclose information.

Under certain circumstances, e.g. when the number of shareholders exceeds 50, closed companies must be transformed into open companies.<sup>34</sup> It is also possible for a closed company to voluntarily transform itself into an open company and vice-versa by following legal requirements, for example, by increasing the charter capital to meet higher minimum requirements.<sup>35</sup>

**!** As this Manual focuses on open joint stock companies, each reference to company, or open company, means “open joint stock company”.

### 3. The Advantages of Open Joint Stock Companies over Other Legal Forms

#### a) Legal Forms of Commercial Entities

Russian law allows for the establishment of the following types of commercial entities:

- Production cooperatives;
- General partnerships;
- Limited partnerships;
- Limited liability companies;

<sup>32</sup> LJSC, Article 64, Clause 1, Paragraph 2.

<sup>33</sup> LJSC, Article 88, Clause 3; Article 92, Clauses 1 and 2.

<sup>34</sup> LJSC, Article 7, Clause 3, Paragraph 3.

<sup>35</sup> LJSC, Article 26.

- Joint stock companies (open or closed); and
- Additional liability companies.

**Company Practices in Russia:** Limited Liability Companies (LLCs) are the most popular form of commercial entity in Russia today, totaling 1,642,095 companies as of 1 January 2003.<sup>36</sup> Closed joint stock companies are the second most common form, totaling 385,697 as of 1 January 2003. Open companies come in at third — 59,815. However, only 33,340 of these companies have reported to the State Statistics Commission as of 1 January 2003, which could be an indication that only these companies are actually operating.

### b) Advantages of Open Compared to Closed Companies and LLCs

The open company offers many advantages, including:

- **Access to investors:** Open companies have greater opportunities to attract investment at lower cost. Furthermore, the scale of capital-intensive companies, such as airlines and power plants, is so large that few individual lenders or equity investor could provide the needed capital.
- **Free transferability of shares:** Shares of the company can be transferred without the consent of other shareholders, the company, or its management.
- **Limitation on the risks to shareholders:** The risks carried by shareholders are limited to the value of their investment and duties set by Russian legislation. Shareholders are not normally liable for the legal and financial obligations of a company.
- **Diversification of risks:** The risks of an open company are spread over a large number of shareholders.

### c) Disadvantages of Open Companies

The principal economic advantage of the open company form is the ease with which it can access the financial markets. However, this special access is not without disadvantages. A number of organizational, legal, and regulatory hurdles

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<sup>36</sup> State Commission of the Russian Federation on Statistics (GOSKOMSTAT), 2003.

## Chapter 2. The General Governance Structure of a Company

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must be cleared for a company to have the right to offer its securities to investors. An open company requires:

- **Compliance with securities regulations**, while LLCs are generally outside the purview of such regulation.
- **A complex organizational structure** that is designed to protect shareholders from abuse and allow professional managers to run the company. The company bears the costs associated with supporting its governing bodies.
- **Compliance with disclosure and other regulations.** An open company must at least publish annual reports and annual financial statements. Reporting may be more frequent. An External Auditor must audit the annual financial statements of the company. The company must comply with more rigorous legislation and regulation, and should follow codes and standards designed to protect shareholder rights. It must ensure the proper registration of shares.
- **Shareholders willing to invest in the company.** The company should be able to attract shareholders willing to risk investing in the company. There are costs associated with marketing an offering to investors and in maintaining good investor relations once shares have been floated.
- **Professional management.** The separation of ownership and control provides investors with the possibility to hire professional managers who devote their efforts and skills to run the company. The separation of ownership and control also provides professional managers with access to the capital needed to manage the company. Finding, developing, and retaining trustworthy professional managers is, however, a difficult task.
- **Higher minimum charter capital** than other legal forms.

### 4. Regulatory Distinctions Based on the Number of Shareholders

There are some differences in the regulation of companies with a small and large number of shareholders with voting rights. These differences are designed to provide for enhanced shareholder protection and/or easier administration of a company with a large number of shareholders.

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Table 2: Difference in Regulation According to the Number of Shareholders	
Number of Shareholders	Specific Provisions
One	<ul style="list-style-type: none"> <li>The company may not have as its sole shareholder another commercial entity comprised of one person.<sup>37</sup></li> <li>The rules on preparing and conducting the General Meeting of Shareholders (GMS) are not applicable.<sup>38</sup></li> </ul>
Fewer than 50 <sup>39</sup>	<ul style="list-style-type: none"> <li>The Supervisory Board is optional.<sup>40</sup></li> </ul>
50 and more	<ul style="list-style-type: none"> <li>The legal form of open company is mandatory.<sup>41</sup></li> <li>An External Registrar is mandatory.<sup>42</sup></li> <li>A Supervisory Board with at least five members is mandatory.<sup>43</sup></li> </ul>
More than 100	<ul style="list-style-type: none"> <li>Mandatory use of voting ballots.<sup>44</sup></li> <li>A Counting Commission is mandatory.<sup>45</sup></li> </ul>
More than 500	<ul style="list-style-type: none"> <li>The External Registrar performs the functions of a Counting Commission.<sup>46</sup></li> </ul>
1,000 and more	<ul style="list-style-type: none"> <li>Independent directors decide on the market value of the company's assets.<sup>47</sup></li> <li>A minimum of seven Supervisory Board members is required.<sup>48</sup></li> <li>A mandatory bid is required.<sup>49</sup></li> <li>→ See also: Part III, Chapter 12, Section B.</li> <li>Voting ballots should be distributed before the GMS.<sup>50</sup></li> <li>Special rules on the approval of related party transactions apply.<sup>51</sup></li> <li>→ See also: Part III, Chapter 12, Section C.</li> </ul>

<sup>37</sup> LJSC, Article 10, Clause 2, Paragraph 2.

<sup>38</sup> LJSC, Article 47, Clause 3.

<sup>39</sup> As far as the law does not provide for a specific provision regarding the respective company, the rules applying to a company with less shareholders continues to apply.

<sup>40</sup> LJSC, Article 64, Clause 1, Paragraph 2.

<sup>41</sup> LJSC, Article 7, Clause 3, Paragraph 2. LJSC, Article 94, Clause 4 provides that closed companies, which were established before January 1, 1996 may have more than 50 shareholders and may choose not to transform into an open company.

<sup>42</sup> LJSC, Article 44, Clause 3, Paragraph 2. This provision is applicable only to companies with more than 50 shareholders.

<sup>43</sup> LJSC, Article 66, Clause 3, Paragraph 1.

<sup>44</sup> LJSC, Article 60, Clause 1, Paragraph 2.

<sup>45</sup> LJSC, Article 56, Clause 1, Paragraph 1.

<sup>46</sup> LJSC, Article 56, Clause 1, Paragraph 2.

<sup>47</sup> LJSC, Article 77, Clause 1, Paragraph 2. The definition of an "independent director" is used only for the purposes of related party transactions.

<sup>48</sup> LJSC, Article 66, Clause 3, Paragraph 2.

<sup>49</sup> LJSC, Article 80, Clause 2.

<sup>50</sup> LJSC, Article 60, Clause 2, Paragraph 2.

<sup>51</sup> LJSC, Article 83, Clause 3.

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Number of Shareholders	Specific Provisions
More than 10,000	<ul style="list-style-type: none"><li>• A minimum of nine Supervisory Board members is required.<sup>52</sup></li></ul>
More than 500,000	<ul style="list-style-type: none"><li>• The charter may provide that voting ballots are published.<sup>53</sup></li><li>• For the rescheduled GMS, the charter may provide for a quorum that is lower than the standard quorum.<sup>54</sup></li></ul>

### B. The Governance Structure of a Company

Legislation provides companies with substantial flexibility in establishing their governance structure. The bodies required by Company Law depend on how many shareholders the company has.

- **For Companies with Less than 50 Shareholders:**

A company with less than 50 shareholders with voting rights must have at least the following bodies:

- GMS;
- General Director; and
- Revision Commission (or a person who performs the functions of the Revision Commission).

In addition, it may establish the following governing bodies at its discretion:

- Supervisory Board; and
- Executive Board.

- **For Companies with 50 and More Shareholders:**

A company with 50 or more shareholders with voting rights must have a Supervisory Board in addition to the bodies required for a company with less than 50 shareholders. An Executive Board may be established at the company's discretion.

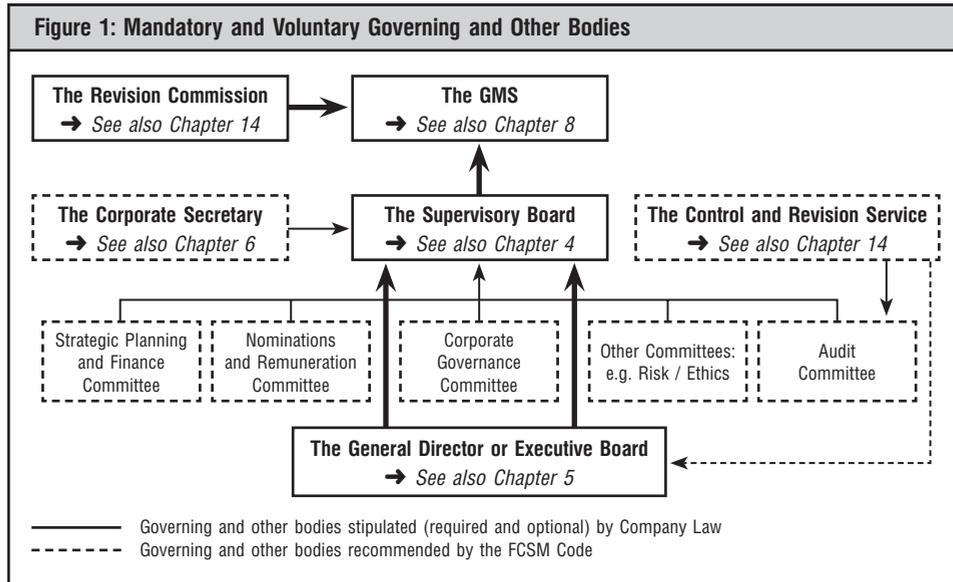
<sup>52</sup> LJSC, Article 66, Clause 3, Paragraph 2.

<sup>53</sup> LJSC, Article 60, Clause 2, Paragraph 4.

<sup>54</sup> LJSC, Article 58, Clause 3, Paragraph 2.

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The mandatory and voluntary governing and other bodies and their responsibilities, as set forth by the Company Law and FCSM Code respectively, are summarized in Figure 1.



Source: IFC, March 2004

### 1. The General Meeting of Shareholders

The GMS is the highest governing body of the company.<sup>55</sup> Through the GMS, shareholders make and approve certain fundamental decisions. The GMS approves nominations for Supervisory Board membership. In addition, it approves the annual report and the financial statements, the External Auditor, the distribution of profits and losses (including the payment of dividends), changes in the charter capital, and extraordinary transactions.

→ See Part III, Chapter 8.

<sup>55</sup> LJSC, Article 47, Clause 1, Paragraph 1.

### 2. The Supervisory Board

The Supervisory Board plays a central role in the corporate governance framework. The Supervisory Board is responsible for guiding and setting the company's strategy and business priorities, including the annual financial and business plan, as well as guiding and controlling managerial performance. It acts in the interests of the company, protects the rights of all shareholders, oversees the work of the General Director and the Executive Board, as well as the systems of financial control. An effective, professional, and independent Supervisory Board is essential for the implementation of good corporate governance practices.

**Best Practices:** Russian companies are essentially able to choose between three different corporate governance frameworks, depending on the structure of the company's supervisory body:<sup>56</sup>

- **The one-tier, or unitary board system** is characterized by a single supervisory body that governs the company, and includes both executive and non-executive members. In such a setting, the supervisory body is often called the Board of Directors. Of particular note is that the position of General Director and Chairman are often held by the same person, although this particularity is forbidden in Russia under the Company Law.<sup>57</sup> This governance structure can facilitate strong leadership structures and efficient decision-making. Non-executive and independent directors, however, play a crucial role in monitoring managers and reducing agency costs. This system is typical for companies based in countries with a common law tradition, for example the U.S. and the U.K.
- **The two-tiered, or dual system**, on the other hand, is characterized by the existence of distinct supervisory and management bodies. The former is commonly referred to as the Supervisory Board, the latter as the Executive Board. Under this system, the day-to-day management of the company is handed down to the Executive Board, which is then controlled by the Supervisory Board (which in turn is elected by the GMS). These two bodies have distinct authorities and their composition cannot be mixed, i.e. members of the Executive Board cannot sit on the Supervisory Board and vice-versa. The advantage of the two-tiered system is a clear oversight

<sup>56</sup> In Russia, the Company Law essentially allows Russian companies to choose between these systems. However, it does not distinguish functionally between the Supervisory Board and the Board of Directors. In fact, these two terms are used interchangeably.

<sup>57</sup> LJSC, Art. 66, Clause 2, Paragraph 2.

mechanism, but it has been criticized for inefficient decision-making. This system is most famously represented in Germany.

- Russian companies are allowed to choose a third governance structure, **the hybrid system**, which is essentially an amalgam between the two above-mentioned models. This system allows companies to establish a Supervisory Board and Executive Board, with the distinction that up to 25% of the Supervisory Board may be comprised of Executive Board members. This system is distinct to Russia.

The Russian legal framework allows companies to essentially choose between these different systems and adapt them to different business environments. Regardless of which system a company chooses, it must realize:

1. There is always a trade-off between efficiency and control. When the agency problem and conflict of interests is high, shareholders may choose the two-tiered system, but must realize that a tight monitoring governance system could tie managers' hands and render business operations and decision-making inefficient. On the other hand, when shareholders and managers trust each other and the company needs better efficiency to explore more business opportunities, the company may choose a more pro-management oriented, one-tier board system.
2. While all systems have many elements in common, important differences do exist and these will affect the supervisory body's authority, structure, and operations, and consequently the duties and obligations of directors.<sup>58</sup>
3. The company should seek to have a supervisory structure that is duly elected by shareholders, is sufficiently independent of management, understands that its role is to represent all shareholders including minorities, and is empowered to guide, supervise, and replace managers.

An open company in Russia with more than 50 shareholders must establish a Supervisory Board.<sup>59</sup> Smaller companies may let the GMS carry out the functions

<sup>58</sup> These differences are embedded in, among other things, national legislation (legal tradition), organizational theory (composition requirements and functional distribution of authorities), and corporate culture, and will affect the supervisory body's authority, structure, and operations. This Manual will not further discuss distinct features of one- and two-tiered systems. The Board of Directors in a unitary system corresponds to the Supervisory Board of a two-tiered system. Further in this Manual, the term "Supervisory Board" will be used to mean both the Supervisory Board and the Board of Directors.

<sup>59</sup> CC, Article 103, Clause 2. This provision appears to be inconsistent with the LJSC, Article 64, Clause 1, which states that the functions of a Supervisory Board may only be carried out by the GMS in a company with less than 50 shareholders with voting rights. However, these two provisions can also be interpreted to complement each other, with the LJSC providing for detailed requirements.

## Chapter 2. The General Governance Structure of a Company

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of the Supervisory Board.<sup>60</sup> However, a Supervisory Board is often useful even for smaller companies that have no legal obligation to establish this body.

→ *For a discussion on the advantages and disadvantages of a Supervisory Board for a smaller company, see Part II, Chapter 4, Section A.1.*

### 3. The Executive Bodies

#### a) The General Director

Every company must have a General Director.<sup>61</sup> The General Director is responsible for the day-to-day management of the company. The General Director is accountable to the Supervisory Board and the GMS. Legislation, the charter and by-laws, and the contract signed between the General Director and the company regulate the authority and election of the General Director, as well as relations with other governing bodies.

→ *On the authority of the General Director, see Part II, Chapter 5, Section A.1.*

#### b) The Executive Board

The Executive Board is composed of the General Director and the top executives of the company. It may be referred to as a “management board”, “managerial board”, “executive team”, “directorate” or “collective executive body” among others. The term “Executive Board” is used for the purposes of this Manual.

A company may, at its discretion, establish an Executive Board.<sup>62</sup> The Executive Board is responsible for the day-to-day management of the company, and carries out the strategy set by the Supervisory Board. While an Executive Board is voluntary, the FCSM Code recommends that all companies establish one, and that the General Director chair it.<sup>63</sup>

→ *For a discussion on the advantages and disadvantages of an Executive Board, see Part II, Chapter 5, Section A.*

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<sup>60</sup> LJSC, Article 64, Clause 1.

<sup>61</sup> LJSC, Article 69, Clause 1, Paragraph 1.

<sup>62</sup> LJSC, Article 69, Clause 1, Paragraph 1.

<sup>63</sup> FCSM Code, Chapter 4, Section 1.1.

### c) The External Manager

The GMS can delegate the authority of the General Director to an External Manager (commercial organization or individual entrepreneur).<sup>64</sup> Under certain circumstances and if provided for by the charter, the Supervisory Board may suspend the powers of the External Manager.

**Company Practices in Russia:** Companies in financial distress often choose to delegate their day-to-day management to an External Manager. External Managers are often firms specializing in crisis or turnaround management and thus ideally suited for such companies.

→ See Part II, Chapter 5, Section A.3.

## 4. The Revision Commission

Companies are required to have a Revision Commission or an individual who performs the functions of a Revision Commission.<sup>65</sup> The Revision Commission is a separate body of the company, elected by the GMS, that oversees the financial and economic activities of the company, and reports directly to the GMS.

→ See Part IV, Chapter 14, Section A.

## 5. Supervisory Board Committees

Supervisory Board committees are not provided for by legislation. However, the FCSM Code recommends the establishment of committees (in particular an Audit Committee) to handle sensitive Supervisory Board functions. The discussion in this Manual as to the authority, composition, and functions of individual Supervisory Board committees is based on recommendations of the FCSM Code and best practices.

→ See Part II, Chapter 4, Section D, as well as Part IV, Chapter 14, Section C.

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<sup>64</sup> LJSC, Article 69, Clause 1, Paragraph 3.

<sup>65</sup> LJSC, Article 85, Clause 1.

## Chapter 2. The General Governance Structure of a Company

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### 6. The Control and Revision Service (Internal Audit Function)

Although it is not mandatory, companies may establish a Control and Revision Service the purpose of which is to carry out internal control procedures on a daily basis. The Control and Revision Service should be independent of the General Director and Executive Board members. The Control and Revision Service reports directly to the Supervisory Board, typically to the Audit Committee,<sup>66</sup> but may also report administratively to the General Director or Executive Board.

→ See Part IV, Chapter 14, Section D.

### 7. The Corporate Secretary

Companies may find it necessary to appoint a Corporate Secretary to ensure that the governing bodies comply with procedural requirements. The Corporate Secretary can assist the Supervisory Board with the organization of the GMS, Supervisory Board meetings, and with the performance of other duties. The Corporate Secretary may also ensure proper information disclosure, maintain corporate records, and notify the Chairman and/or the Supervisory Board of violations of corporate procedures.<sup>67</sup>

→ See Part II, Chapter 6.

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<sup>66</sup> FCSM Code, Chapter 8, Article 1.1.2.

<sup>67</sup> FCSM Code, Chapter 5.

# Chapter 3

## The **Internal Corporate Documents**

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### **The Chairman's Checklist**

- ✓ Does the company have a valid charter, with provisions on the protection of shareholder rights, equitable treatment of shareholders, division of authority among the governing bodies, and information disclosure?
- ✓ How detailed is the charter compared to by-laws? Do the charter and by-laws merely copy the exact language of legislation?
- ✓ Is the charter freely available to interested parties and accessible on the internet?
- ✓ Has the company developed by-laws as recommended by the Federal Commission for the Securities Market's Code of Corporate Conduct? If yes, were these by-laws approved by the Supervisory Board or the General Meeting of Shareholders? Does the company regularly consult and follow its by-laws?
- ✓ Has the company adopted its own corporate governance code? If so, does the company code touch upon the principles of fairness, responsibility, transparency, and accountability? Does the company code provide recommendations on the relationship between the corporate bodies, notably the interaction between the Supervisory Board and General Director or Executive Board?
- ✓ Has the company identified a core set of values? Does the company have a code of ethics based on these values?

The charter is the founding document of a company. No company can be established without a charter.<sup>68</sup> A charter establishes a company, and determines its structure and purpose. It is fundamental to a company's system of corporate governance, ensuring the protection and equitable treatment of shareholders, distribution of authorities between the governing bodies, and disclosure and transparency of the company's activities. It also plays an important public role in relation to third parties since it provides information about the company, especially on its corporate governance system. The company is required to register the charter and its amendments with a state registration authority.<sup>69</sup>

<sup>68</sup> Civil Code (CC), Article 98, Clause 3; LJSC, Article 11, Clause 1.

<sup>69</sup> CC, Article 51; Law on Joint Stock Companies (LJSC), Article 11, Clause 1; Articles 13 and 14; Law on State Registration of Legal Entities, Article 12.

The company may, and under certain circumstances must, adopt by-laws that expand the charter provisions. By-laws are useful in regulating detailed procedures for the company's governing bodies and can help avoid unwieldy charters that are difficult to understand and amend.

Company-level corporate governance codes and ethics codes allow the company to make its governance structure more transparent, and demonstrate the company's commitment to good corporate governance and good business practices.

This chapter examines corporate governance issues as related to charter provisions, and explains when and how a charter and by-laws can be amended, and how the amendments are registered. It further touches upon the important role that company-level corporate governance and ethics codes play.

### A. The Company Charter

#### 1. Charter Provisions

The charter must include minimum provisions related to the company's structure and charter capital, the authority of the governing bodies, and shareholder rights. Regardless of the company's activities, ownership and management structure, the charter must include the following mandatory provisions:<sup>70</sup>

- Full and abbreviated name of the company;
- Location of the company;
- Legal type of company (open or closed);
- Number, nominal value, and types of shares (common or preferred), and the classes of preferred shares issued by the company;
- Shareholder rights by type and class;
- Amount of charter capital;
- Structure and authority of the company's governing bodies, and the procedure for the adoption of decisions by these bodies;
- Procedure for preparing and conducting the General Meeting of Shareholders (GMS);

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<sup>70</sup> LJSC, Article 11, Clause 3.

## Chapter 3. The Internal Corporate Documents

- Issues that must be resolved by a super-majority or a unanimous vote of the GMS, the Supervisory Board, and the Executive Board;
- Period within which the company holds the Annual General Meeting of Shareholders (AGM);
- Information concerning branches and representative offices of the company;<sup>71</sup> and
- Amount of the reserve fund and the amount of annual deductions from the net profits of the company to the reserve fund.<sup>72</sup>

In addition to the foregoing mandatory provisions, the Company Law requires certain additional provisions under specific circumstances.

Finally, other provisions are permitted as long as they do not conflict with the Company Law or other legislation.<sup>73</sup> These provisions give the company and its shareholders great flexibility in organizing the company structure, including its activities, financial structure, and shareholder rights. In other words, the charter largely determines the characteristics and activities of the company.

→ *For more information on specific types of charter provisions, see the model charter in Part VI, Annex 2 and the table of charter provisions in Annex 3.*

**Company Practices in Russia:** Many Russian companies copy the exact language of legislation into the charter and/or include many extraneous details. Neither practice contributes to the quality of the charter. The charter should include the information required by legislation (not the text of legislation) and other provisions that are needed for sound corporate governance. For example, the Company Law's Article 78, Clause 1 defines extraordinary transactions and permits the company charter to expand upon the definition. Instead of copying this provision, the company may want to specify what other transactions important to the company shall require the same approval regime as extraordinary transactions. In addition, the charter may stipulate provisions that are recommended by the FCSM Code and best suit the company's objectives.

<sup>71</sup> LJSC, Article 5, Clause 6.

<sup>72</sup> LJSC, Article 35, Clause 1, Paragraphs 1 and 2.

<sup>73</sup> LJSC, Article 11, Clause 3, Paragraph 3.

## 2. When to Amend the Charter

The charter must be amended when changes occur that affect any mandatory provisions. For example, amendments to the charter are required when the company:

- Reorganizes;<sup>74</sup>
- Changes the amount of its charter capital;<sup>75</sup>
- Changes the rights attached to different types and/or classes of shares;<sup>76</sup> and
- Establishes or liquidates a branch or a representative office.<sup>77</sup>

The charter must also be brought into conformity with changes in legislation when new requirements are introduced that affect charter provisions.

## 3. Who Can Amend the Charter

As a rule, only the GMS has the authority to amend the charter.<sup>78</sup> However, under specific circumstances, special regimes, as illustrated in Table 1, are introduced whereby the amendments can be made by:<sup>79</sup>

- The GMS, but upon the submission of a prior report by the Supervisory Board;
- The Supervisory Board; or
- A relevant state agency.

<b>Circumstances</b>	<b>Competent Body</b>	<b>Legal Requirements</b>
The company increases the charter capital by increasing the nominal value of issued shares.	The GMS	<ul style="list-style-type: none"> <li>• Report by the Supervisory Board on the results of the share issue with a new nominal value; and</li> <li>• GMS' decision to increase the charter capital.</li> </ul>

<sup>74</sup> LJSC, Article 15.

<sup>75</sup> LJSC, Article 11, Clause 3; Articles 28 and 29.

<sup>76</sup> LJSC, Article 11, Clause 3; Articles 31 and 32.

<sup>77</sup> LJSC, Article 11, Clause 3; Article 5, Clause 6.

<sup>78</sup> CC, Article 103, Clause 1; Article 48, Clause 1. There appears to be an inconsistency between the LJSC, Article 12, and the CC, Article 103, Clause 1, Section 1. The CC states that the decision to amend the charter falls under the exclusive authority of the GMS, while the LJSC provides for circumstances when other bodies can amend the charter.

<sup>79</sup> LJSC, Article 12, Clauses 2–5.

## Chapter 3. The Internal Corporate Documents

<b>Circumstances</b>	<b>Competent Body</b>	<b>Legal Requirements</b>
The company increases the charter capital by issuing additional shares.	The GMS or Supervisory Board	<ul style="list-style-type: none"><li>• Report by the Supervisory Board on the results of the share issue; and</li><li>• Decision of the GMS or the Supervisory Board, if the Supervisory Board has such authority, to increase the charter capital.</li></ul>
The company decreases the charter capital by purchasing outstanding shares.	The GMS	<ul style="list-style-type: none"><li>• Report by the Supervisory Board on the acquisition of shares; and</li><li>• GMS' decision to decrease the charter capital.</li></ul>
The Supervisory Board establishes or liquidates representative offices and/or branches.	The Supervisory Board	<ul style="list-style-type: none"><li>• The Supervisory Board's decision to establish or liquidate representative offices and/or branches.</li></ul>
The government, a state agency, or a municipal entity create or terminate a golden share arrangement.	The government, a state agency, or a municipal entity	<ul style="list-style-type: none"><li>• The decision of the government, the state body, or a municipal entity to create or terminate golden shares.</li></ul>

### 4. How to Amend the Charter

Preparing amendments to the charter requires legal drafting skills and specialized knowledge of legislation.

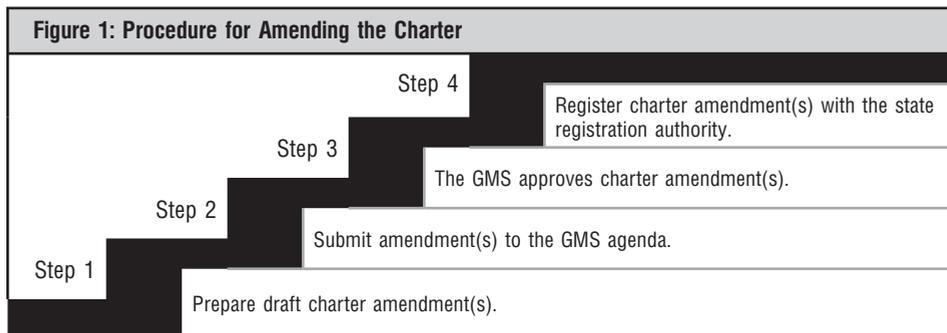
**Best Practices:** It is accepted practice that the company through its legal counsel/department prepares the charter amendments in cooperation with outside legal consultants and with the participation of the Corporate Secretary. The General Director should closely follow the process.

There are three ways a company can amend its charter:

- Changing existing charter provisions;
- Adding new charter provisions; or
- Approving an entirely new version of the charter (redrafting the charter), which is useful when many changes must be made.

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Figure 1 illustrates the procedure for amending the charter. The procedure for restating the charter is similar.



Source: IFC, March 2004

The GMS has the authority to approve the charter amendments with a  $\frac{3}{4}$ -majority vote of shareholders participating in the GMS (unless the charter provides for a higher percentage of votes).<sup>80</sup> The approval of charter amendments that limit the rights of preferred shareholders requires two votes:<sup>81</sup>

- A  $\frac{3}{4}$ -majority vote of all preferred shareholders of a particular class whose rights will be affected as a result of charter amendments (unless the charter provides for a higher percentage of votes); and
- A separate  $\frac{3}{4}$ -majority vote of all other shareholders with voting rights participating in the GMS (unless the charter provides for a higher percentage of votes).

### 5. Registration of Charter Amendments

All amendments made to the charter must be registered with a state registration authority.<sup>82</sup> As of 1 June 2004, the Ministry of Taxes and Collections is responsible for the registration of legal entities and charter amendments, and now serves

<sup>80</sup> LJSC, Article 49, Clause 4.

<sup>81</sup> LJSC, Article 32, Clause 4, Paragraph 2.

<sup>82</sup> The procedure for registering the charter is regulated by the Civil Code, the Company Law, and the Law on the State Registration of Legal Entities. See LJSC, Article 14.

### Chapter 3. The Internal Corporate Documents

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as the state registration authority.<sup>83</sup> The state imposes a fee for registering charter amendments of not more than RUR 2,000 each time amendments are registered.<sup>84</sup>

The state registration authority must register charter amendments within five working days<sup>85</sup> from the day the company has submitted the following documents:<sup>86</sup>

- Signed application form;
- Decision to amend the charter;
- Text of charter amendments; and
- Receipt verifying the payment of the state duty for the registration.

The official submission date is the date on which the state registration authority receives all required documents in the correct form.<sup>87</sup> The requirements for documents and the form of the written application are specified by law.<sup>88</sup>

The registration is officially completed when the state registration authority registers the new charter or charter amendments in the registration books.<sup>89</sup>

In case of charter amendments related to branches and/or representative offices, simplified procedures require the company to submit the following documents:

- A signed notification form; and
- The Supervisory Board's decision regarding a branch and/or a representative office.

The state registration authority must register charter amendments in the registration books within five days of the day the documents are submitted to the registration authority. The company is entitled to receive proof of registration in writing from the register.<sup>90</sup>

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<sup>83</sup> Resolution of the Government of the Russian Federation No. 319, 17 May 2002.

<sup>84</sup> Law on State Duty, Article 4, Clause 1.

<sup>85</sup> Law on State Registration of Legal Entities, Article 8, Clause 1.

<sup>86</sup> Law on State Registration of Legal Entities, Article 17, Clause 1.

<sup>87</sup> Law on State Registration of Legal Entities, Article 9, Clause 2.

<sup>88</sup> Resolution of the Government of the Russian Federation No 439, 19 June 2002.

<sup>89</sup> Law on State Registration of Legal Entities, Article 11, Clause 2.

<sup>90</sup> Law on State Registration of Legal Entities, Article 19, Clauses 1 and 2.

### 6. When Charter Amendments Become Effective

Charter amendments become effective at different times for the company and its shareholders, as well as third parties:

- **The company and its shareholders:** Charter amendments become effective upon the GMS approval;
- **Third parties:** Charter amendments become effective only after registration (or the proper notification of the state registration authority in case of amendments to provisions related to branches and representative offices).<sup>91</sup> However, if third parties relied upon the amendments after they were adopted by the relevant governing body, but before state registration, the company must comply with these amendments as if they had been registered at the time of the *bona-fide* act.<sup>92</sup>

### 7. Disclosure of the Charter

The charter is an important source of information for shareholders and potential investors. The original charter document must be kept at the offices of the executive bodies.<sup>93</sup> Shareholders, the External Auditor, and other interested parties have the right to inspect the original charter at the company's headquarters within seven days after filing a request.<sup>94</sup>

**Best Practices:** It is good practice for companies to allow shareholders to view the original charter and provide shareholders with copies within five days.<sup>95</sup>

Copies of the latest registered charter and amendments must be provided to shareholders on request. The company may not charge shareholders for more than the cost of making copies.<sup>96</sup>

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<sup>91</sup> Law on State Registration of Legal Entities, Article 19, Clause 3; LJSC, Article 14, Clause 2.

<sup>92</sup> CC, Article 52, Clause 3.

<sup>93</sup> LJSC, Article 89, Clause 2.

<sup>94</sup> LJSC, Article 11, Clause 4; Article 91, Clause 2.

<sup>95</sup> Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), Chapter 7, Section 3.1.1.

<sup>96</sup> LJSC, Article 91, Clause 2.

**Best Practices:** It is customary to provide copies of the charter to shareholders free of charge.

In practice, there is little justification for not providing shareholders and other interested parties with immediate access to the charter by posting it on the internet, which is a technically simple and cost effective solution.

→ For more on information disclosure included in the charter, see Part IV, Chapter 13.

## B. The By-Laws of the Company

### 1. Types of By-Laws

By-laws are internal company documents that supplement and specify charter provisions. The following by-laws are mandatory:<sup>97</sup>

- By-laws for the Revision Commission;
- By-laws for the executive bodies if established; and
- By-laws for branches and representative offices if established.

Other by-laws are optional. A company has the discretion to adopt other by-laws providing detailed procedures for the company's governing bodies. In any case, the company's by-laws must be consistent with the charter and cannot conflict with legislation.

**Best Practices:** Although certain provisions must be or should remain stipulated in the charter, by-laws have several advantages:

- By-laws do not need to be registered with the state registration authority, saving the company resources by avoiding registration fees and bureaucratic procedures;
- By-laws require a simple majority vote of shareholders with voting rights participating in the GMS, making it easier to adjust to changing circumstances;

<sup>97</sup> LJSC, Article 85, Clause 2, Paragraph 2; Article 70, Clause 1; Article 5, Clause 4.

- By-laws provide for the same level of shareholder protection as the charter, since the GMS approves most by-laws, in particular, those affecting shareholder rights; and
- Not all by-laws require shareholder approval. Some by-laws are approved by the Supervisory Board which requires simpler approval procedure compared to the GMS.

At the same time, certain provisions must appear either in the charter or by-laws:<sup>98</sup>

- The way the GMS approves procedural (technical) decisions;
- The procedure for organizing and conducting Supervisory Board meetings; and
- The quorum needed for conducting valid Executive Board meetings.

## 2. How to Adopt and Amend By-Laws

If by-laws for the governing bodies are to be adopted, they must be approved by a simple majority vote of shareholders participating in the GMS.<sup>99</sup> The Supervisory Board submits the proposed by-laws for the GMS approval unless the charter provides otherwise.<sup>100</sup>

The Supervisory Board has the power to adopt by-laws other than those for the company's governing bodies, for example, on information disclosure. The charter may grant the General Director or Executive Board the right to adopt all by-laws with the exception of those for the governing bodies.<sup>101</sup>

The Supervisory Board, and possibly the Executive Board, adopts by-laws with a simple majority vote. The charter and by-laws can stipulate a greater percentage of votes necessary for the Supervisory Board to approve by-laws.<sup>102</sup>

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<sup>98</sup> LJSC, Article 49, Clause 5; Article 68, Clause 1; Article 70, Clause 2.

<sup>99</sup> LJSC, Article 48, Clause 1, Section 19; Article 49, Clause 2.

<sup>100</sup> LJSC, Article 49, Clause 3.

<sup>101</sup> LJSC, Article 65, Clause 1, Section 13.

<sup>102</sup> LJSC, Article 68, Clause 3, Section 1.

Table 2: An Overview of Company By-Laws				
By-Laws by Topic	Who Approves the By-Laws	Required	Recommended	See in Annexes
Executive Board	GMS	✓	✓	✓
Revision Commission	GMS	✓	✓	✓
Branches and Representative Offices <sup>103</sup>	Supervisory Board or Executive Bodies <sup>104</sup>	✓		
GMS	GMS		✓	✓
Supervisory Board	GMS		✓	✓
Control and Revision Service (Internal Audit Function)	Supervisory Board		✓	✓
Information Policy	Supervisory Board or Executive Bodies		✓	✓
Dividend Policy	Supervisory Board or Executive bodies		✓	✓
Corporate Secretary	Supervisory Board or Executive Bodies		✓	✓
Ethical Standards	Supervisory Board		✓	✓
Risk Management	Supervisory Board or Executive Bodies		✓	✓
Supervisory Board Committees	Supervisory Board		✓	✓

### C. Company Codes of Corporate Governance

A company-level corporate governance code is a principle-based statement on the company's corporate governance practices. It is intended to make the company's governance structure more transparent and demonstrate the company's commitment to good corporate governance by developing and furthering:

- Responsible, accountable, and value-based management;
- An effective Supervisory Board and executive bodies that act in the best interests of the company and its shareholders, including minority shareholders, and seek to enhance shareholder value in a sustainable manner; and

<sup>103</sup> Only if these are established by the company.

<sup>104</sup> The General Director or the Executive Board can only do so if authorized by the charter.

- Appropriate information disclosure and transparency, as well as an effective system of risk management and internal control.

By adopting, following, and updating a company-level corporate governance code on a regular basis, the company confirms its desire to demonstrably lead and promote good corporate governance. To foster the confidence of its shareholders, employees, investors, and the public, a company-level corporate governance code should, however, go beyond the established legal and regulatory framework and embrace both nationally and internationally recognized best corporate governance practices.

**Company Practices in Russia:** Some Russian companies have voluntary corporate governance codes or guidelines in addition to their charter and by-laws. Most of these codes are brief and simple statements of principle. They generally reflect the desire of the Supervisory Board and management to conduct the operations of the company in an honest, fair, legal, and socially responsible manner.

Company codes and guidelines may cover a vast number of topics including:

- **General issues of corporate governance:**
  - Goals and objectives of the company;
  - Relationship between the shareholders and the Supervisory Board;
  - Relationship between the Supervisory Board and the General Director or Executive Board; and
  - Relationship between controlling shareholders and minority shareholders.
- **Good Supervisory Board Practices:**
  - Composition, including the number of independent directors;
  - Number and structure of committees;
  - General working procedures; and
  - Remuneration of non-executive directors.
- **Good Executive Board Practices:**
  - Executive remuneration; and
  - Interaction and relationship with the Supervisory Board.
- **Shareholder Rights:**
  - On organizing and conducting the GMS;
  - Minority shareholder protection;
  - Disclosure of related party transactions; and
  - The company's dividend policy.

- **Disclosure and Transparency Issues:**
  - Internal control function, including risk management;
  - Policy on the use of audit and consulting services and External Auditor rotation; and
  - Accounting and disclosure policies and standards.
- **Accountability of the Company to Stakeholders:**
  - Communications with investors and investor relations.

Which topics to cover will depend upon the issues of greatest relevance to the company.

As a rule, company codes are approved by the Supervisory Board, communicated to shareholders and investors, and published on the company's internet site. Company codes or guidelines must be consistent with legislation, as well as the charter and by-laws, and should generally follow the provisions of the FCSM Code. They cannot, however, replace the charter and by-laws.

→ See Part VI, Annex 4 for a model company-level corporate governance code.

## D. Company Codes of Ethics

### 1. What Is a Code of Ethics

A Code of Ethics (also referred to as a code of conduct, or ethics or responsibility statement) is a basic guide of conduct that imposes duties and responsibilities on a company's officers and employees towards its stakeholders, including, among others, colleagues, customers and clients, business partners (e.g. suppliers), government, and society.

### 2. Why Adopt a Code of Ethics

A company may wish to adopt a Code of Ethics because it:

- **Enhances the company's reputation/image:** A company's reputation and image constitutes an integral, if intangible, part of its assets. Establishing a Code of Ethics is an effective way to communicate the value a company places on good business practices.

- **Improves risk and crisis management:** A Code of Ethics can bring potential problems to management's and directors' attention before a full-blown crisis occurs in that a Code of Ethics sensitizes and encourages employees to react to ethical dilemmas.
- **Develops a corporate culture and brings corporate values to the forefront:** A Code of Ethics developed by and widely distributed to the company's officers and employees can help build a cohesive corporate culture, based on a shared set of values, that helps guide employees in their daily work.
- **Advances stakeholder communications:** A Code of Ethics also has a strong demonstration effect towards the company's stakeholders during times of crisis, communicating the company's commitment to ethical behavior and underlining that possible transgressions are exceptions rather than the rule.
- **Avoids litigation:** A Code of Ethics, in combination with an effective ethics program, can help minimize litigation risk resulting from fraud, conflict of interest, corruption and bribery, and insider trading.

### 3. How to implement a Code of Ethics

Every company is different in terms of size and industry, and each has a different business culture, set of values, and ethically sensitive operational areas. A Code of Ethics should reflect these differences.

A company's Code of Ethics should go beyond simple rules and, instead, focus on core values. Before drafting a Code of Ethics, it is fundamental that a company has identified and formulated its values.<sup>105</sup>

Drafting a Code of Ethics goes beyond paper. Developing a Code is at least as much process as outcome. In assessing the need for a Code of Ethics, the company should begin by studying its internal ethics climate, the amount and type of ethical guidance its employees and officers receive, and the risk the company faces without such a Code.<sup>106</sup> As a second step, the company should seek buy-in from every part of the organization, from senior management to workers, if the Code is to truly

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<sup>105</sup> For more information on how to design, manage, and implement Code of Ethics, see Kenneth Johnson and Igor Abramov, *Business Ethics: A Manual for Managing a Responsible Business Enterprise* (Washington, D.C.: U.S. Department of Commerce, 2004). See also: [www.mac.do.gov/ggp](http://www.mac.do.gov/ggp).

<sup>106</sup> Kenneth Johnson and Igor Abramov, *Business Ethics: A Manual for Managing a Responsible Business Enterprise*, Chapter 3, pp. 45–46 and Chapter 5, pp. 93–97.

### Chapter 3. The Internal Corporate Documents

guide the company's ethical practice.<sup>107</sup> Most importantly, the company should ensure that a broad consultative process takes place within the company.<sup>108</sup> By the time the Code of Ethics is submitted for the Supervisory Board's approval, every employee should be familiar with the Code and have played a role in drafting it — a process that ensures buy-in and helps with its implementation.

The company must also recognize that the “tone at the top” matters, and that public and demonstrable commitment by senior management and directors is a key component to the implementation of a Code of Ethics.

A Code of Ethics should be user-friendly, i.e. provide practical guidance to the company's management and employees on how to handle ethics problems that may arise in the day-to-day course of business.<sup>109</sup> In support of a Code of Ethics, the company may wish to establish an ethics training program,<sup>110</sup> as well as appoint an ethics officer and create an ethics office and/or establish a Supervisory Board Ethics Committee to advise and educate officers and employees, and provide guarantees for confidential counseling.

The Code of Ethics should be subject to continuous change, revision, and renewal by the Supervisory Board's Ethics Committee.

→ *For a model company Code of Ethics, see Part VI, Annex 5.*

<sup>107</sup> Kenneth Johnson and Igor Abramov, *Business Ethics: A Manual for Managing a Responsible Business Enterprise*, pp. 53–56.

<sup>108</sup> Many companies choose to establish a working group or task force to produce a first draft of the company's Code of Ethics for the Supervisory Board's approval, consisting of representatives from every level. See also: Kenneth Johnson and Igor Abramov, *Business Ethics: A Manual for Managing a Responsible Business Enterprise*, pp. 57–61.

<sup>109</sup> The Code of Ethics itself should include a practical procedure for raising an ethical issue (“first go to your supervisor, then to...”), and even a procedure for suggesting changes in the Code. The Code should also include an ethical decision-making model (“Step 1: Check your facts, Step 2...”). See also: Kenneth Johnson and Igor Abramov, *Business Ethics: A Manual for Managing a Responsible Business Enterprise*, Chapter 6, pp. 138–144.

<sup>110</sup> A practical ethics training program should be organized around cases that might arise within the context of an employee's daily work and be organized in an interactive manner. See also: Kenneth Johnson and Igor Abramov, *Business Ethics: A Manual for Managing a Responsible Business Enterprise*, Chapter 7, pp. 155–165.

FOR NOTES

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