Chapter 1

An Introduction to **Corporate Governance**

Table of Contents

A. CORPORATE GOVERNANCE EXPLAINED 4

1. *Defining Corporate Governance* 4
2. *The Role of Stakeholders* 7
3. *A Brief History* 8
4. *The International Scope of Good Corporate Governance* 10
5. *Distinguishing Corporate Governance* 11

B. THE BUSINESS CASE FOR CORPORATE GOVERNANCE 12

1. *Stimulating Performance and Improving Operational Efficiency* 13
2. *Improving Access to Capital Markets* 15
3. *Lowering the Company's Cost of Capital and Raising the Value of Assets* 16
4. *Building a Better Reputation* 18

C. THE COST OF CORPORATE GOVERNANCE 18

D. THE CORPORATE GOVERNANCE FRAMEWORK IN RUSSIA 20

1. *Specifics of Corporate Governance in Russia* 20
2. *The Legal and Regulatory Framework* 21
3. *The FCSM Code of Corporate Conduct* 23
4. *The Institutional Framework* 25

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.[1]

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*

[1] 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).

shareholders, and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently."[2]

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.[3] Conflicts may also exist within each governing body, such as between shareholders (majority vs. minority, controlling vs. non-controlling,

---

[2] OECD Principles of Corporate Governance (see also: www.oecd.org).

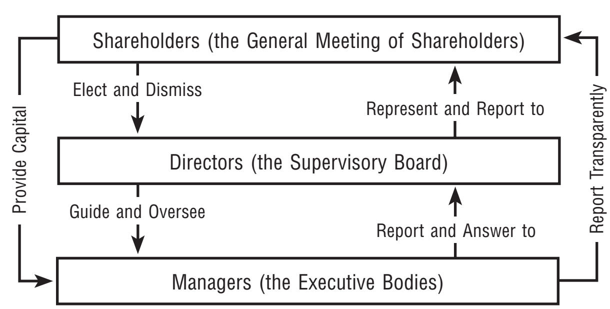
[3] The principal-agent problem is defined as follows by the Oxford Dictionary of Economics: "The problem of how Person (A) can motivate Person (B) to act for (A's) benefit rather than following his self-interest." In a company setting, Person (A) is the investor (or principal) and (B) the manager (or 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.

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.[4]

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

Figure 1: The Corporate Governance System



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

[4] Corporate Governance: A Framework for Implementation, the World Bank. See also: http://www.worldbank.org/html/fpd/privatesector/cg/docs/gcgfbooklet.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.[5]

[5] OECD Principles of Corporate Governance, Annotations to Principle III on the Role of Stakeholders in Corporate Governance. See also: 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

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.

Figure 2: A Brief History of Corporate Governance

- **1600s:** The **East India Company** introduces a Court of Directors, separating ownership and control (U.K., the Netherlands)
- **1776: Adam Smith** in the «Wealth of Nations» warns of weak controls over and incentives for management (U.K.)
- **1844:** First Joint Stock Company Act (U.K.)
- **1931: Berle and Means** publish their seminal work «The Modern Corporation and Private Property» (U.S.)
- **1933/34:** The Securities Act of 1933 is the first act to **regulate the securities markets**, notably registration disclosure. The 1934 Act delegated responsibility for enforcement to the SEC (U.S.)
- **1968:** The EU adopts the first **company law directive** (EU)
- **1987:** The **Treadway Commission** reports on fraudulent financial reporting, confirming the role and status of audit committees, and **develops a framework for internal control**, or COSO, published in 1992 (U.S.).
- **Early 1990s:** Polly Peck (£1.3bn. in losses), BCCI and Maxwell (£480m) **business empires collapse**, calling for improved corporate governance practices to protect investors (U.K.)
- **1992:** The **Cadbury Committee** publishes the first code on corporate governance; and in 1993, companies listed on **U.K.'s Stock Exchanges** are required to disclose governance on a «comply or explain» basis (U.K.)
- **1994:** Publication of the **King Report** (S. Africa)
- **1994, 1995: Rutteman** (on Internal Control and Financial Reporting), **Greenbury** (on Executive Remuneration), and **Hampel** (on Corporate Governance) reports are published (U.K.)
- **1995:** The Russian **Law on Joint Stock Companies** is adopted (Russia)
- **1995:** Publication of the **Vienot Report** (France)
- **1996:** Publication of the **Peters Report** (the Netherlands)
- **1996:** The Russian **Law on Securities Market** is adopted (Russia)
- **1998:** Publication of the **Combined Code** (U.K.)
- **1999:** OECD Publishes the first international benchmark, the **OECD Principles of Corporate Governance**
- **1999:** Publication of the **Turnbull** guidance on internal control (U.K.)
- **2001:** The Russian **Law on Joint Stock Companies** is significantly amended (Russia)
- **2001: Enron Corporation**, then the seventh largest listed company in the U.S., declares bankruptcy (U.S.)
- **2001**: The **Lamfalussy** report on the Regulation of European Securities Markets (EU) is published
- **2002:** Publication of the **German Corporate Governance Code** (Germany)
- **2002:** Publication of the FCSM **Russian Code of Corporate Conduct** (Russia)
- **2002:** The **Enron collapse** and other corporate scandals lead to the **Sarbanes-Oxley Act** (U.S.); the **Winter** report on company law reform in Europe is published (EU)
- **2003:** The **Higgs** report on non-executive directors is published (U.K.)
- **2004:** The Parmalat scandal shakes Italy, with possible EU-wide repercussions (EU).

t

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.[6] 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.[7]

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.

[6] For a complete list of country codes of corporate governance, see the website of the European Corporate Governance Institute under www.ecgi.com.

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

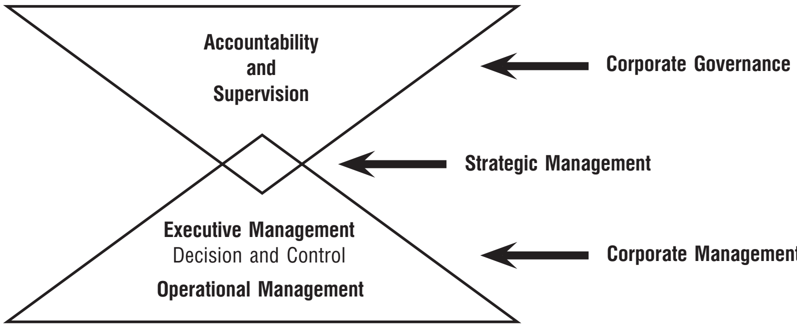
Best Practices: The FCSM Code states that: "The principles of corporate conduct set forth in this chapter form the basis of the recommendations contained in the chapters of this Code that follow, and also serve as fundamental guidelines to be observed in the absence of specific recommendations. These 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."[8]

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.

[8] FCSM Code, Chapter 1, Introduction.

Figure 3: The Activities of Governance and Management Compared



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 profitably, corporate governance is and remains distinct from these concepts.

B. The Business Case for Corporate Governance

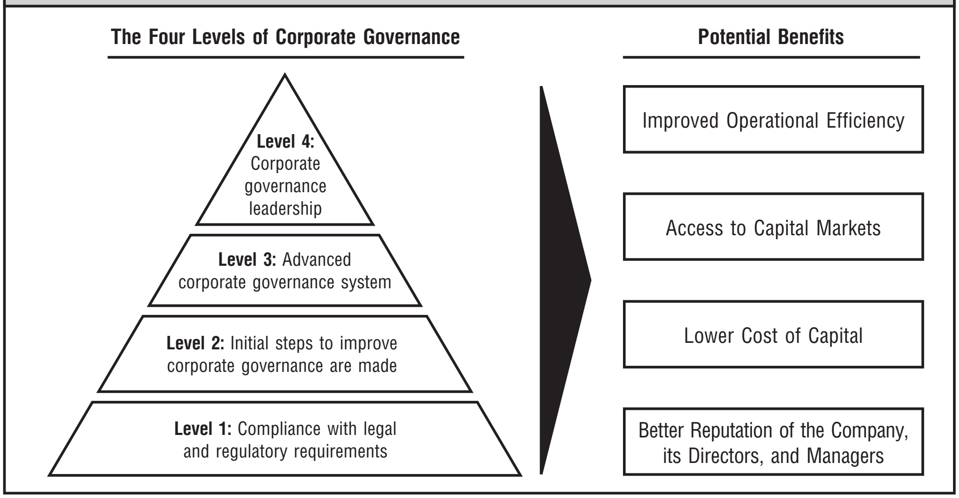
Good corporate governance is important on a number of different levels.

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.

Figure 4: Levels and Potential Benefits of Good Corporate Governance



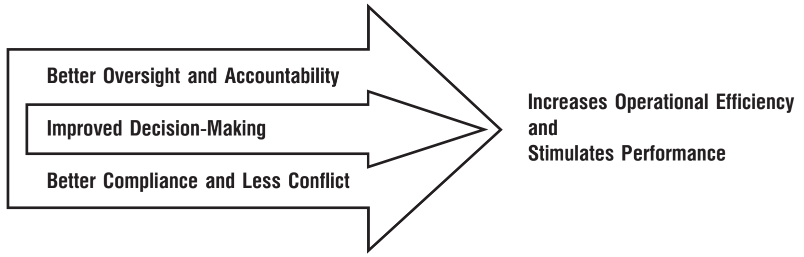
Source: IFC, March 2004

➜ *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.

Figure 5: Advantages of Corporate Governance



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,[9] which, in turn,

[9] Paul A. Gompers, Joy L. Ishii and Andrew Metrick, Corporate Governance and Equity Prices, NBER Working Paper No. w8449, August 2001.

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.

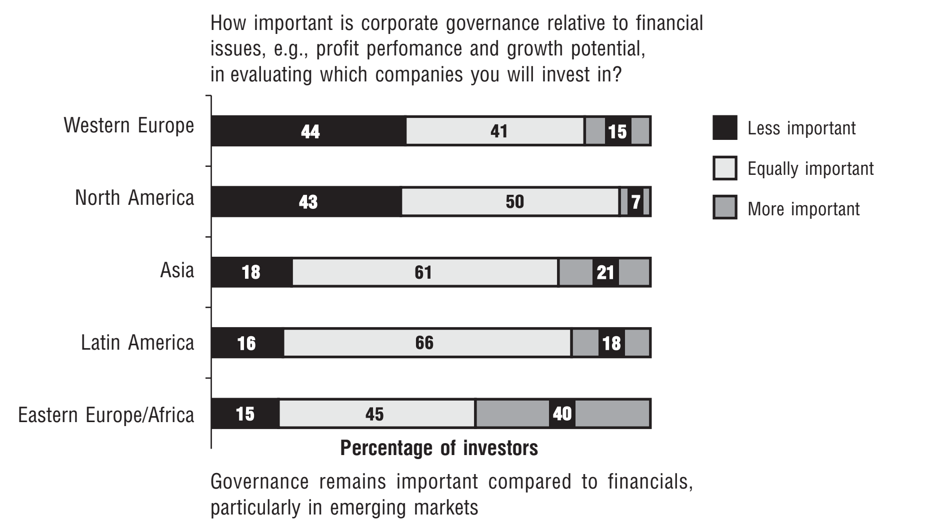
2. Improving Access to Capital Markets

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.

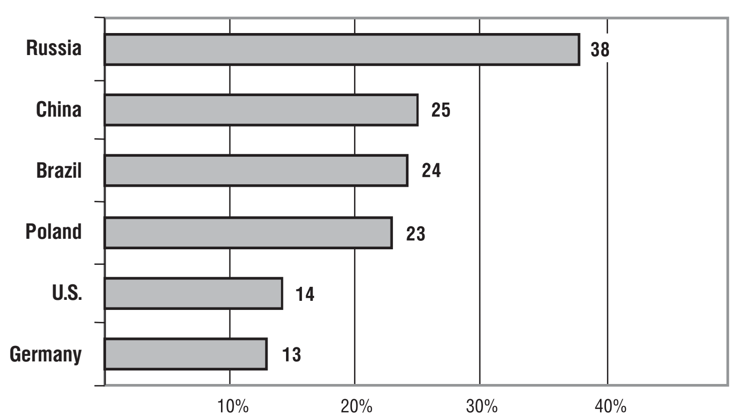
3. Lowering the Company's Cost of Capital and Raising the Value of Assets

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 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.[10] 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.[11]

Figure 7: A Premium for Better Corporate Governance



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

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

[11] 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).[12] Moreover, the 42 largest companies by market capitalization make up 98% of the total value of all listed companies in Russia;[13] 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.

---

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

13 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.[14] 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-

[14] 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.

Figure 8: Principal Laws and Regulations Impacting Corporate Governance

Law / Regulation	Applicability	Comments
Civil Code	All commercial entities	Regulates basic governance framework
Company Law	Joint Stock Companies (JSCs)	Regulates founding, operation, and liquidation/reorganization of JSCs
Securities Law	JSCs that have publicly issued securities	Regulates procedures of issuance and circulation of securities; information disclosure
FCSM Regulations	JSCs that have publicly issued securities	Expands upon the Company and Securities Law
Secondary Regulations (tax, bankruptcy, etc.)	All commercial entities	Regulates specific issues for commercial entities
Listing Requirements	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.[15] 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.[16] 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-

[15] Law on Joint Stock Companies (LJSC), Article 1, Clause 2.

[16] LJSC, Article 1, Clauses 3–5.

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.[17] 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.[18]

---

[17] OECD Principles of Corporate Governance, Annotations to the OECD Principles of Corporate Governance, Ensuring an effective corporate governance framework. See also: www.oecd.org.

[18] 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."[19] 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.[20] 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.[21] Similar rules on both levels are stipulated for listing securities on the RTS stock exchange. [22]

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:[23]

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.

---

[19] 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.

[20] Annex 1d, Rules of Listing, Access to Placement and Trade on the Moscow Interbank Currency Exchange, Section 9.

[21] Annex 1d, Rules of Listing, Access to Placement and Trade on the Moscow Interbank Currency Exchange, Section 10.

[22] Rules for the Access to Circulation of Securities, RTS stock exchange, Articles 5.2.6 and 5.3.4.

[23] 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.

Table 1: Corporate Governance Related Institutions in Russia	
Courts	
The Supreme Arbitration Court	www.arbitr.ru
Public Sector Institutions	
Federal Service for the Financial Markets	www.fcsm.ru
Ministry of Economic Development and Trade	www.economy.gov.ru
State Duma	www.duma.gov.ru

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