



# 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.

<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> LJS, Article 2, Clause 1; CC, Article 96, Clause 1.

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

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

<sup>29</sup> LJS, 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> LJS, Article 7, Clauses 2 and 3.

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

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	<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.

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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.

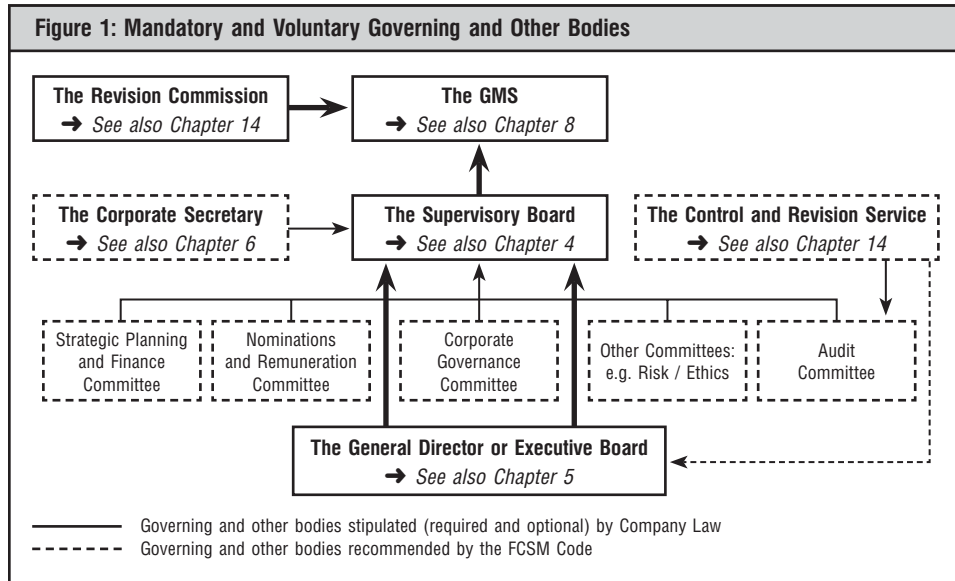
<sup>52</sup> LJSC, Article 66, Clause 3, Paragraph 2.

<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.

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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.

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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.