Chapter 4

The **Supervisory Board**

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The Chairman's Checklist

The Supervisory Board's authority:

- ✓ Is the Supervisory Board's focus on protecting the interests of the company and its shareholders? Do all Supervisory Board members understand the role and priorities of the Supervisory Board? Does the Supervisory Board have sufficient powers according to the charter to fulfill its oversight duties? Have these authorities been properly communicated? Does the Supervisory Board use its powers in practice?
- ✓ What is the Supervisory Board's role with respect to the company's governance, organization of the General Meeting of Shareholders, protection of company assets, resolution of conflicts, and supervision of internal controls and risk management? How effective is the Board in guiding and setting strategy? Does the Supervisory Board have the tools to properly oversee the operational and financial performance of the company? Is a succession plan in place, in particular for the General Director?
- ✓ Is the Supervisory Board's authority distinct from management's, both on paper and in practice?

The Supervisory Board's election:

- ✓ Who nominates candidates to the Supervisory Board? Is sufficient information provided to shareholders on nominees? How does the Supervisory Board influence the nomination process?
- ✓ Does the Supervisory Board ensure that all shareholders understand how cumulative voting works?

The Supervisory Board's composition:

- ✓ Has the Supervisory Board designed, articulated, and implemented policies relating to its size, composition and mix-of-skills, breadth of experience, and other pertinent qualities?
- ✓ Is the Supervisory Board's composition, considering its competencies and mix-of-skills, suited to its oversight duties and the development of its strategy?
- ✓ How effectively does the Supervisory Board work as a team?

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- ✓ Does the company have independent directors? Is the Supervisory Board constituted of a majority (in the case of companies with an Executive Board, a $^3/_4$-majority) of non-executive directors?
- ✓ How effective is the Supervisory Board's leadership, both at the Board and committee level?
- ✓ Is the number of directors consistent with the needs of the company? Does the company have enough directors to establish Supervisory Board committees?

The Supervisory Board's structure and committees:

- ✓ Does the Supervisory Board have Audit, Nominations and/or Remuneration committees? What are the costs and benefits of these or other committees? Are there sufficient independent (or non-executive) directors to chair and sit on these committees? Do Supervisory Board committees have sufficient resources, both human and financial, to properly fulfill their functions?
- ✓ How well informed are non-committee members about the committee's deliberations? Is the information prepared by the committee for the Supervisory Board adequate for effective decision-making?
- ✓ Do Audit Committee members have sufficient expertise on financial issues? Do they have access to information from the Revision Commission, the External Auditor, the Internal Audit Function, and the executive bodies on the financial and economic activities of the company?

The Supervisory Board's working procedures:

- ✓ Has the Supervisory Board identified, prioritized, and scheduled key issues that should be reviewed on a regular basis? Has the Board identified the information it requires to properly analyze these key issues?
- ✓ Does the Chairman take an active role in organizing the work of the Supervisory Board? Does the Supervisory Board meet regularly in accordance with a fixed schedule?
- ✓ Does the Chairman encourage a free and open exchange of views?
- ✓ Are procedures in place that ensure the proper preparation and conducting of Supervisory Board meetings, e.g. advance notification on agenda issues, distribution of materials and documents, proper determination of the quorum, voting through absentee ballots, and preparation of the minutes? How efficient are Supervisory Board meetings in practice?

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- ✓ Is the information provided to directors focused, succinct, and to the point, allowing for effective decision-making? Are key issues and risks highlighted? Do the materials contain annexes with further relevant details?
- ✓ How does the Supervisory Board ensure that it properly oversees the executive bodies? Does it receive periodic reports and updates from the executive bodies? Does the Supervisory Board invite members of the executive bodies to Board meetings to inform its members on key issues? How well does the Supervisory Board interact with senior management, including the General Director? Does the Board provide wise counsel and clear direction? Does it challenge management sufficiently? How does it balance oversight against micro-management?

The Supervisory Board's duties and liabilities:

- ✓ Do all Supervisory Board members understand their duty to act reasonably and in good faith in the best interests of the company and its shareholders? Do directors properly prepare themselves for Board meetings? Does the Supervisory Board give proper consideration to the interests of other stakeholders?
- ✓ Does the company have contracts with directors? Do such contracts describe their duties and liabilities? Are directors indemnified?

The Supervisory Board's self-evaluation and training:

- ✓ Does the Supervisory Board conduct annual self-evaluations? Has the Board developed performance indicators or benchmarks for its work? Is this process credible and are the results made available to shareholders?
- ✓ Does the Supervisory Board conduct regular training events on corporate governance and other issues? Do all directors attend training sessions? Does the company hold an induction training for new directors to acquaint them with the company's strategy and operations?

The Supervisory Board's remuneration:

- ✓ Is the remuneration of directors competitive? Are all directors paid the same amount? Is the remuneration structured in a manner that provides incentives to take on additional responsibilities, for example, the chairmanship of a committee?

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- ✓ Does the remuneration package jeopardize a director's independence? Does the total remuneration package constitute a significant portion of a director's total annual income?
- ✓ Does the Supervisory Board and its Nominations and Remuneration Committee periodically review the remuneration paid to directors? Is the remuneration of directors disclosed on an individual basis?
- ✓ Does the company have a policy in place that prohibits personal loans or credits to its directors?
- ✓ Are executive and non-executive directors compensated in the same manner? Does the company have a policy on (not) remunerating executive directors for their service on the Supervisory Board beyond their executive remuneration package?

An effective, professional, and independent Supervisory Board is essential for good corporate governance.[1] The Supervisory Board acts in the best interests of the company and its shareholders. It sets the strategy of the company, protects shareholder rights, and oversees the executive bodies and financial operations of the company.[2]

While the Supervisory Board cannot substitute for talented professional managers, or change the economic environment in which a company operates, it can influence the performance of the company through its strategic oversight and control over management. Supervisory Board activities may go entirely unnoticed when an economy is strong, share prices are rising, and everything appears to be going well. On the other hand, when things go badly, the Supervisory Board becomes the center of attention and the importance of the Supervisory Board becomes clear.

[1] The Supervisory Board in a two-tiered board system corresponds to a Board of Directors in a unitary board system. Although the Company Law in Russia allows both unitary and two-tiered board systems to exist, in addition to a hybrid model, it functionally does not distinguish between the Supervisory Board and the Board of Directors. Throughout this Manual, the term «Supervisory Board» is used.

See Part I, Chapter 2, Section B.2 for a more detailed discussion on different Board models.

[2] Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), Chapter 3.

Mini-Case: Certainly, the catastrophic collapse of Enron in the U.S. served to focus public and government attention on boards and corporate governance. The following illustration shows some of the shortcomings of the Enron Board that contributed to the company's downfall, the loss of many thousands of jobs and pensions, and ultimately a loss in faith in U.S. financial markets. On 7 May 2002, the U.S. Senate concluded the following with respect to the role of the Board in Enron's collapse and bankruptcy:[3]

- **Fiduciary Failure:** The Enron Board failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the U.S.
- **Lack of Independence:** Financial ties between the company and certain Board members compromised the independence of the Enron Board.
- **Conflicts of Interests:** Despite clear conflicts of interests, the Enron Board approved an unprecedented arrangement allowing Enron's Chief Financial Officer to establish and operate private equity funds that transacted business with Enron and profited at Enron's expense.
- **Excessive Compensation:** The Enron Board approved excessive compensation for company executives, failed to monitor the cumulative cash drain caused by Enron's FY 2000 annual bonus and performance unit plans, and failed to monitor or halt a company-financed, multi-million dollar, personal credit line.
- **High-Risk Accounting:** The Enron Board knowingly allowed Enron to engage in high risk accounting practices.
- **Extensive Undisclosed Off-the-Book Activity:** The Enron Board knowingly allowed Enron to conduct billions of dollars in off-the-book activity to make its financial condition appear better than it was, and failed to ensure adequate public disclosure of material off-the-books liabilities that contributed to Enron's collapse.

The legal regime of the Supervisory Board is characterized by mandatory requirements, but is also accompanied by a degree of flexibility enabling companies to tailor their internal organization to their own needs and circumstances.

[3] 107th Congress, 2nd Session, Report by the Permanent Subcommittee on Investigations, The Role of the Board of Directors in Enron's Collapse, 8 July 2002.
See also: http://www.senate.gov/~gov_affairs/070902enronboardreport.pdf.

This chapter describes the authority, election and dismissal, composition, structure, working procedures, duties and liabilities, evaluation, and remuneration of the Supervisory Board. It also discusses corporate governance principles and standards found in the Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), and other best practices.

A. The Supervisory Board's Authority

1. When to Establish a Supervisory Board

A company with 50 or more shareholders with voting right must establish a Supervisory Board.[4] Companies with fewer than 50 shareholders with voting rights may choose not to establish a Supervisory Board.

Best Practices: Supervisory Boards can add value even to companies with fewer than 50 shareholders, specifically when they take on an advisory function. Such supervisory bodies are often referred to as "Advisory Boards" and can provide outside expertise and guidance to the company's General Director and managers.

If a company with fewer than 50 shareholders with voting rights decides not to have a Supervisory Board, then:[5]

- The charter must identify a person or body to organize the General Meeting of Shareholders (GMS) and approve the agenda of the GMS; and
- The GMS has the authority to make decisions on all other matters that fall under the Supervisory Board's authority.

A company that wishes to establish a Supervisory Board will want to take the following steps illustrated in Figure 1:

[4] Law on Joint Stock Companies (LJSC), Article 64, Clause 1.

[5] LJSC, Article 64, Clause 1, Paragraph 2.

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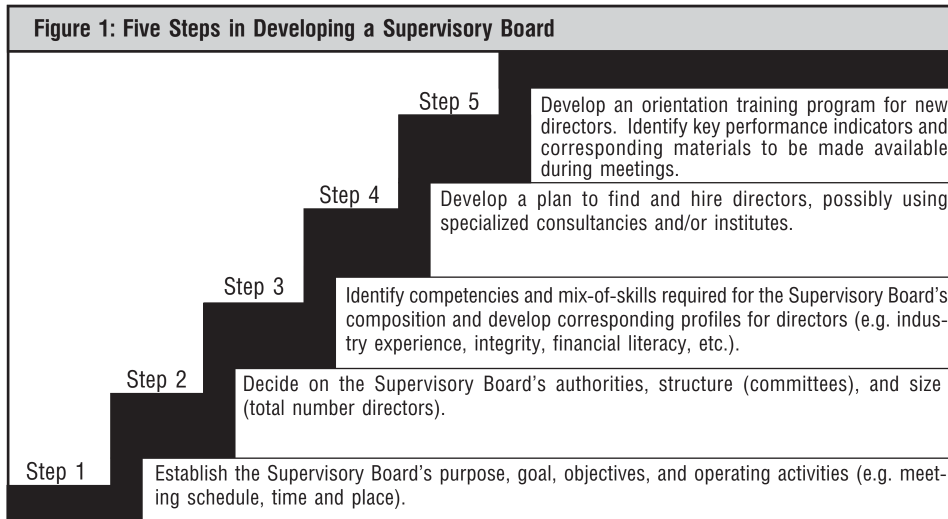
Figure 1: Five Steps in Developing a Supervisory Board



Source: IFC, March 2004

2. An Overview of the Supervisory Board's Authority

The Company Law defines the Supervisory Board's authority.[6] The Supervisory Board is responsible for setting the company's strategy and business priorities, as well as guiding and controlling managerial performance, and for making decisions on matters that do not fall under the GMS authority. In essence, the role of the Supervisory Board is to direct and not to manage. In some cases, the charter may delegate certain GMS powers to the Supervisory Board. The charter can assign additional powers to the Supervisory Board as well.[7]

Best Practices: When additional powers and authorities are granted to the Supervisory Board in the charter, these should correspond with the typical functions of the Supervisory Board to avoid ambiguity with respect to the division of powers between the GMS, Supervisory Board, General Director, and/or Executive Board.[8]

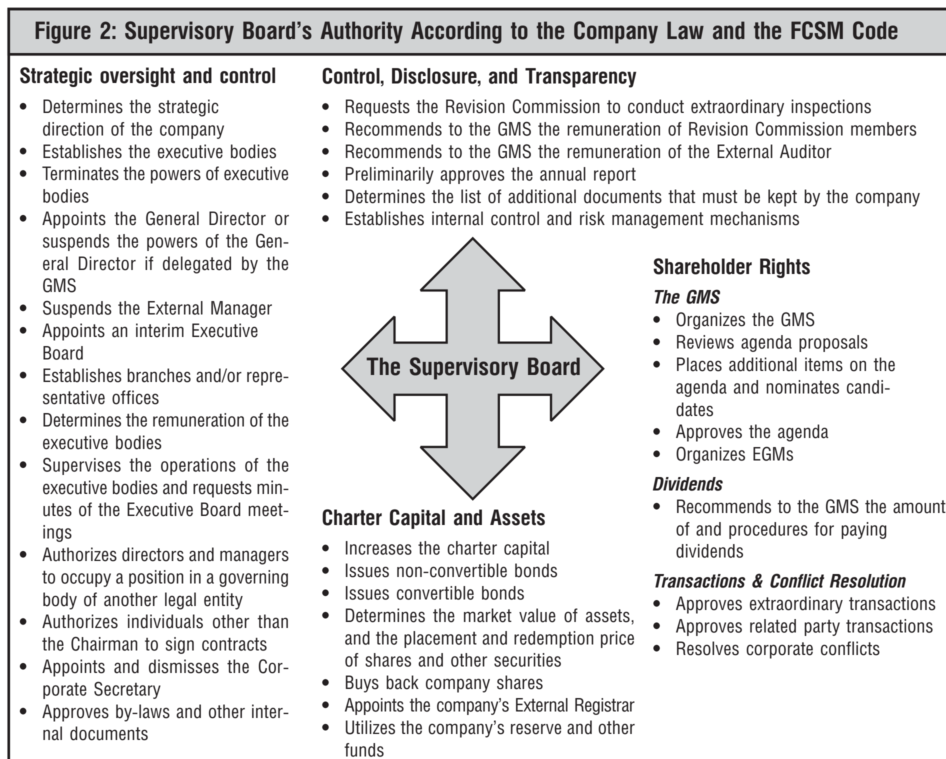
Matters under the Supervisory Board's authority cannot be delegated to the General Director or the Executive Board.[9]

[6] LJSC, Article 65.
[7] LJSC, Article 65, Clause 1, Paragraph 2, Section 18.
[8] FCSM Code, Chapter 3, Section 1.5.
[9] LJSC, Article 65, Clause 2.

As illustrated in Figure 2, the Supervisory Board has the authority to make decisions in the following areas:

- The strategic oversight and control over management, as well as the election (when provided by the charter) and oversight of the General Director and Executive Board;
- The organization of the GMS;
- The charter capital and assets of the company;
- Disclosure and transparency; and
- Other areas determined by the Company Law and charter.

Figure 2: Supervisory Board's Authority According to the Company Law and the FCSM Code



Source: IFC, March 2004

3. The Supervisory Board's Authority in Relation to Strategic Oversight and Control

The Supervisory Board plays an important role in the company's strategic oversight and control. The Supervisory Board has the following authorities in this area:

a) Setting Company Priorities and Strategic Direction

The Supervisory Board has the authority to determine the priorities and strategic direction of the company.[10]

Best Practices: The Supervisory Board should:[11]

- Set the strategic direction of the company;
- Approve financial and business plans on an annual basis; and
- Establish and oversee internal control procedures.

The Supervisory Board sets the company's strategic direction in the context of the market environment, the financial position, and other factors.[12] The strategic and business plans of the company should be reviewed and evaluated at least on an annual basis. The evaluation should also cover production, marketing, and planned investments. Finally, the Supervisory Board should approve a single document that contains financial projections for one year.

Good corporate governance principles also suggest that:

- The General Director and the Executive Board seek the approval of the Supervisory Board for transactions that fall outside the scope of the financial and business plan (non-standard operations);[13]
- The company develop by-laws or other internal documents with detailed procedures for the General Director and the Executive Board for obtaining the approval of operations that fall outside the scope of the financial and business plan;[14] and
- The Supervisory Board be given the right to veto the decision of the General Director and the Executive Board to implement any non-standard operations, provided such veto can be justified.[15]

The Supervisory Board is not, however, involved in the day-to-day management of the company, which is the responsibility of the executive bodies.

[10] LJSC, Article 65, Clause 1, Section 1.
[11] FCSM Code, Chapter 1, Sections 3.1. and 7.1.
[12] FCSM Code, Chapter 3, Section 1.1.
[13] FCSM Code, Chapter 4, Section 1.2.
[14] FCSM Code, Chapter 4, Section 1.2; Chapter 8, Section 2.2.3.
[15] FCSM Code, Chapter 8, Section 2.2.3.

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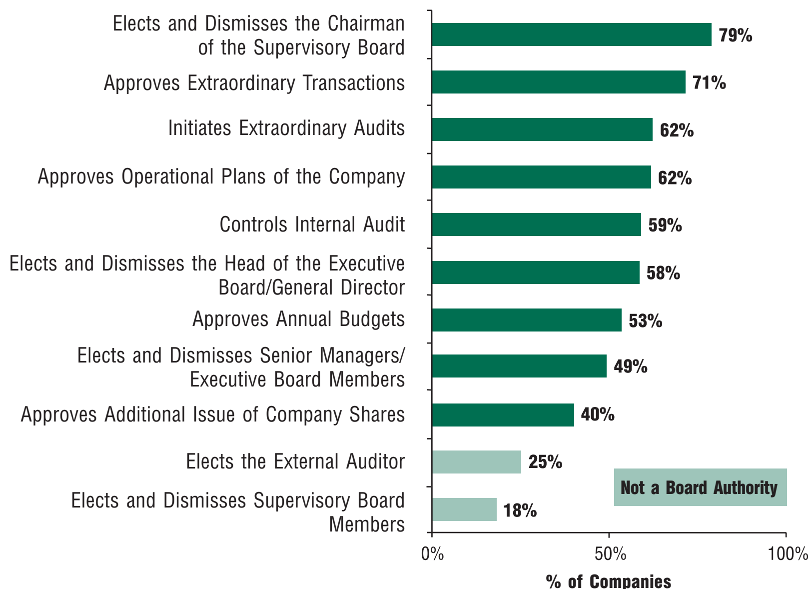
Company Practices in Russia: The most common functions performed by Supervisory Boards of Russian companies include electing and dismissing the Chairman of the Supervisory Board (79%), approving extraordinary transactions (71%), approving operational plans (62%), and approving annual budgets (53%), as depicted in Figure 3.[16] In addition, Supervisory Boards generally elect and dismiss the Chairman of the Executive Board (General Director), top managers, and Executive Board members. However, one in four Supervisory Boards decides upon the selection of an independent External Auditor, and 18% elect and dismiss their own members. Under Russian legislation, these rights are reserved for shareholders.[17] Companies that violate rules regarding the election of Auditors also tend to violate rules regarding the appointment and dismissal of Supervisory Board members.

Figure 3: Functions Performed by Supervisory Boards in Russia



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

[16] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.2.1, page 25, August 2003 (see www.ifc.org/rcgp).

[17] LJSC, Article 48, Clause 1, Sections 4 and 10.

b) Establishing the Executive Bodies

The Supervisory Board has the authority to establish the executive bodies provided that the charter gives this authority to the Supervisory Board.[18] If the charter is silent on this matter, then the Company Law dictates that this is a power of the GMS.

c) Terminating the Executive Bodies' Powers

With the power to create executive bodies comes the authority to terminate them.[19] The Supervisory Board cannot, however, terminate the authority of the executive bodies if the authority to elect such bodies lies with the GMS.

d) Suspending the Executive Bodies' Powers

If the power to create and terminate executive bodies remains with the GMS, the charter can provide the Supervisory Board with the authority to suspend the powers of the General Director and External Manager. The Supervisory Board is not, however, able to suspend the powers of the Executive Board.

e) Appointing Interim Executive Bodies

When the power to create executive bodies resides with the GMS and the charter provides the Supervisory Board with the authority to suspend the powers of the General Director or External Manager, the Supervisory Board shall appoint interim executive bodies together with the decision on the suspension of powers, as illustrated in Table 1.

Table 1: Instances When the Supervisory Board May Appoint Interim Executive Bodies	
An interim General Director[20]	• When the Supervisory Board has exercised the right to suspend the powers of the General Director provided by the charter; or • When the General Director is unable to fulfill his duties; or • When the Supervisory Board has exercised the right to suspend the powers of the External Manager provided by the charter; or • When the External Manager is unable to fulfill its duties.

18 LJSC, Article 48, Clause 1, Section 8. See also: LJSC, Article 65, Clause 1, Section 9; Article 69, Clause 3, Paragraph 1.

19 LJSC, Article 48, Clause 1, Section 8. See also: LJSC, Article 65, Clause 1, Section 9; Article 69, Clause 4, Paragraph 2.

20 LJSC, Article 69, Clause 4, Paragraphs 3 and 4.

Table 1: Instances When the Supervisory Board May Appoint Interim Executive Bodies	
An interim Executive Board[21]	• When the charter has reserved the power to establish the Executive Board for the GMS; and • When the number of acting Executive Board members is less than the quorum set by the charter or by-laws.

In these circumstances, the decision to appoint an interim executive body must be accompanied by a decision to hold an Extraordinary General Meeting of Shareholders (EGM) to elect new executive bodies.

Best Practices: A reasonable timeframe to hold the EGM is within 60 days of the appointment of the interim executive body.

f) Concluding Contracts with the Executive Bodies

The Chairman has the power to sign contracts between the company and members of the executive bodies.[22] The Supervisory Board can also designate a person other than the Chairman to enter into contracts with members of the executive bodies.[23]

Best Practices: Although legislation does not specify who determines the terms of contracts with managers, including their remuneration, it is recommended that the Supervisory Board do this.[24]

It is common practice internationally for the Supervisory Board's Remuneration Committee, chaired and comprised of independent directors, to set the remuneration of the General Director and other senior managers. The German Corporate Governance Code, for example, states that the compensation of the Executive Board is determined by the Supervisory Board based on a performance assessment. Criteria for determining the level of compensation are: the tasks of the Executive Board members; their performance; the economic (financial) situation of the company; and, in particular, the performance outlook compared to competing companies.[25]

➜ *For more information on executive remuneration, see Chapter 5, Section G.*

[21] LJSC, Article 70, Clause 2, Paragraph 1.

[22] LJSC, Article 69, Clause 3, Paragraph 2.

[23] LJSC, Article 69, Clause 3, Paragraph 2.

[24] FCSM Code, Chapter 3, Section 1.4.3.

[25] The German Corporate Governance Code, 4.2.2. See also: www.ecgi.org/codes/country_documents/germany/code_200305_en.pdf and www.corporate_governance_code.de

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g) Supervising the Executive Bodies' Operations

The executive bodies must be accountable to the Supervisory Board and shareholders.[26]

Best Practices: The executive bodies normally report to shareholders during the GMS. Most shareholders, in particular minority shareholders, are not able to effectively supervise management. This task is the responsibility of the Supervisory Board, which oversees the executive bodies on behalf of all shareholders.[27] In order for the Supervisory Board to fulfill its oversight function, the charter needs to provide it with sufficient authorities on a wide range of issues, including the authority to supervise the financial and business operations of the company.[28]

When establishing and selecting an Executive Board, an appropriate balance must be struck between exercising oversight over the General Director and allowing him sufficient autonomy to conduct corporate affairs. The dangers of weak oversight are well known; managers can operate in their own personal interests, and defraud shareholders. There are, on the other hand, dangers associated with excessive oversight; these include micro-management, and the politicization of managerial decision-making. Both weak and excessive oversight can lead to economic inefficiencies and legal problems. As a consequence, charters, by-laws, and other policy documents should be developed with a view towards dividing responsibilities among the governing bodies of the company on the basis of what body is best suited for a particular task. Managerial tasks should, clearly, be left to professional managers. Oversight tasks should be carried out by oversight bodies, such as the Supervisory Board and GMS.

The Supervisory Board, for example, has the authority to request the minutes of Executive Board meetings.[29] The Supervisory Board further decides whether the General Director or an Executive Board member can occupy a position in a governing body of another legal entity,[30] in order to avoid a conflict of interest that may prevent the General Director and other executives from properly fulfilling their functions.

[26] LJSC, Article 69, Clause 1.

[27] See also: FCSM Code, Chapter 3, Section 1.4.1.

[28] FCSM Code, Chapter 3, Section 1.2.1. The FCSM Code recommends that these procedures be developed taking into consideration the requirements of the Law on Countering Legalization of Income Generated by Illegal Means (Money Laundering).

[29] LJSC, Article 70, Clause 2, Paragraph 2.

[30] LJSC, Article 69, Clause 3, Paragraph 4.

Best Practices: The Supervisory Board must understand what to monitor. A number of key issues every Supervisory Board will want to closely monitor should include the:

- Company's overall performance, especially in comparison to competing companies;
- Executive bodies' compliance with law and internal procedures, including on corporate governance, risk management and internal control, as well as ethics;
- Executive bodies' performance, both at the team and individual level;
- Implementation of the company's strategy;
- Company's marketing and sales targets;
- Company's financial results; and
- Relations with key stakeholders, including the company's shareholders, as well as employees, suppliers, and customers.

h) Appointing the Corporate Secretary

Although the Company Law is silent about the Supervisory Board's authority to appoint the Corporate Secretary, the Supervisory Board can be vested with this power in the charter.[31]

Best Practices: Appointing the Corporate Secretary, and defining the terms and conditions of the contract with the Corporate Secretary, including the amount of remuneration, should fall under the Supervisory Board's authority.[32] Moreover, the Corporate Secretary should be accountable to and supervised by the Supervisory Board in accordance with the terms and conditions of his employment contract.

➜ *For more information on the Corporate Secretary, see Chapter 6.*

i) Approving By-laws

The Supervisory Board approves the by-laws and other internal documents, excluding those that must be approved by the GMS or the executive bodies of the company.[33]

[31] LJSC, Article 65, Clause 1, Section 18.

[32] FCSM Code, Chapter 5, Section 2.1.

[33] LJSC, Article 65, Clause 1, Section 13.

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Best Practices: The FCSM Code advises that the Supervisory Board approve the by-laws dealing with the company's:

- Dividend policy;[34]
- Information policy;[35]
- Ethical standards;[36]
- Control and Revision Service;[37]
- Risk management;[38]
- Audits of the financial and business activity of the company;[39] and
- Corporate Secretary.[40]

➜ *For more information on by-laws and their approval, see Part I, Chapter 3, Section B, as well as model by-laws contained in Annexes under Part VI.*

j) Establishing Branches and Representative Offices

The establishment of the company's branches and representative offices lies within the Supervisory Board's authority.[41] However, the Company Law does not address the Supervisory Board's authority to terminate branches and representative offices.

4. The Supervisory Board's Authority in Relation to Shareholder Rights

a) Organizing the General Meeting of Shareholders[42]

The Supervisory Board has the authority, and sometimes the obligation, to include items on the agenda.[43]

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[34] FCSM Code, Chapter 9, Section 1.1.1.

[35] FCSM Code, Chapter 7, Section 4.1.1; Chapter 3, Section 2.3.1.

[36] FCSM Code, Chapter 3, Section 4.12.

[37] FCSM Code, Chapter 8, Section 1.1.1.

[38] FCSM Code, Chapter 3, Section 1.2.2.

[39] FCSM Code, Chapter 8, Section 3.1.3.

[40] FCSM Code, Chapter 5.

[41] LJSC, Article 65, Clause 1, Section 14.

[42] The general aspects of organizating the GMS, including the role of the Supervisory Board, are discussed at length in Chapter 8. In this section, this process is approached from the perspective of the Supervisory Board and focuses on the GMS agenda.

[43] LJSC, Article 49, Clause 3; Article 54, Clause 2; LJSC, Article 53, Clause 7, Paragraph 2.

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The Supervisory Board must include items on the agenda of the GMS upon request of a shareholder (or a group of shareholders) owning at least 2% of voting shares. Items that the Supervisory Board can add to the agenda of the GMS are the approval of:[44]

- Reorganizations;[45]
- The composition and liquidation of a Creditors' Committee;[46]
- The amount of dividends;[47]
- The transfer of the General Director's authority to an External Manager;[48] and
- The annual report.[49]

➜ *For more information on who can request an EGM, see Part III, Chapter 8, Section D.*

There are certain items that only the Supervisory Board may include on the agenda of the GMS, unless the charter also provides this right to shareholders and/or other permitted parties. These items are shown in Figure 4.

b) Resolving Corporate Conflicts

Best Practices: A key Supervisory Board function is to establish a system of compliance with corporate procedures. The Supervisory Board's responsibility is to take all necessary steps to prevent and resolve conflicts that may arise between shareholders and the company.[50] It may appoint officers to implement systems of enforcement. The Supervisory Board may also form a Conflict Resolution Committee to this end.

➜ *For more information on corporate conflicts and on the Supervisory Board's Conflict Resolution Committee, see Section D.2 of this Chapter and Part V, Chapter 17, Sections G.2 and G.3, respectively.*

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[44] There appears to be an inconsistency between LJSC, Articles 16–21, which provides that decisions of the GMS on different types of reorganization and liquidation of the company can be submitted to the agenda of the GMS only by the Supervisory Board, and LJSC, Article 49, Clause 3, which states that these decisions can be submitted to the agenda of the GMS by the Supervisory Board if the charter does not provide otherwise.

[45] LJSC, Article 16, Clause 2; Article 17, Clause 2; Article 18, Clause 2; Article 19, Clause 2; and Article 20, Clause 2.

[46] LJSC, Article 21, Clause 2.

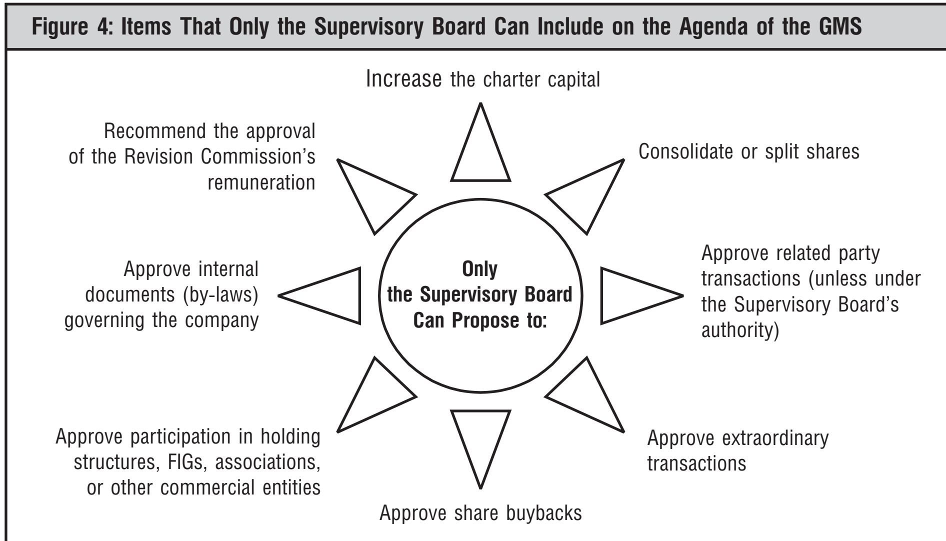
[47] LJSC, Article 42, Clause 3.

[48] LJSC, Article 69, Clause 1, Paragraph 3.

[49] LJSC, Article 88, Clause 4; Article 54, Clause 2.

[50] FCSM Code, Chapter 3, Sections 1.3.1-1.3.2.

Figure 4: Items That Only the Supervisory Board Can Include on the Agenda of the GMS



Source: IFC, March 2004

5. The Supervisory Board's Authority in Relation to Assets and the Charter Capital

The Supervisory Board has the authority to decide on whether to issue non-convertible bonds and other non-convertible securities if the charter does not provide otherwise.[51] In contrast, the Supervisory Board has the authority to decide on the issue of convertible bonds and other convertible securities only if this authority has not been provided to the GMS in the charter.[52]

In addition, the Supervisory Board has the authority to set the market value of assets, the placement price, and the redemption price of shares and other securities.[53]

➜ *For more information on charter capital, see Part III, Chapter 9, and on bonds and other securities, see Chapter 11.*

[51] LJSC, Article 65, Clause 1, Section 6; Article 33, Clause 2, Paragraph 1.

[52] LJSC, Article 65, Clause 1, Section 6; Article 33, Clause 2, Paragraph 2.

[53] LJSC, Article 65, Clause 1, Section 7.

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6. The Supervisory Board's Authority in Relation to Control, Disclosure, and Transparency

a) Preliminarily Approving the Annual Report

The executive bodies are responsible for preparing financial statements and for financial reporting.[54] The Supervisory Board verifies and authorizes the annual report and financial statements for submission to the GMS for final approval.[55] This must be done no later than 30 days before the Annual General Meeting of Shareholders (AGM) is held.

b) Implementing Risk Management

The Supervisory Board should ensure that systems for evaluating and managing risks are in place. Some of the key Supervisory Board duties are outlined in the box below and in Figure 5.

Best Practices: Risk management is an important function of the Supervisory Board.[56] The Supervisory Board should ensure that systems are established that enable the company to assess and control risks.[57] Among other things, the Supervisory Board should:

- Approve risk management procedures and ensure compliance with such procedures (these procedures should provide that the company and its employees notify the Supervisory Board promptly of all substantial deficiencies in risk management mechanisms);
- Analyze, evaluate, and improve the effectiveness of the internal risk management procedures on a regular basis;
- Develop adequate incentives for the executive bodies, departments, and employees to apply internal control systems;
- Establish a Risk Management Committee of the Supervisory Board when necessary; and
- Ensure that the company complies with legislation and charter provisions.

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[54] LJSC, Article 88, Clause 2.

[55] LJSC, Article 88, Clause 4.

[56] Companies engaged in banking, investment, or insurance activities should, at a minimum, follow the risk management requirements established by regulatory authorities of the Russian Federation, such as the Central Bank.

[57] FCSM Code, Chapter 3, Section 1.2.2.

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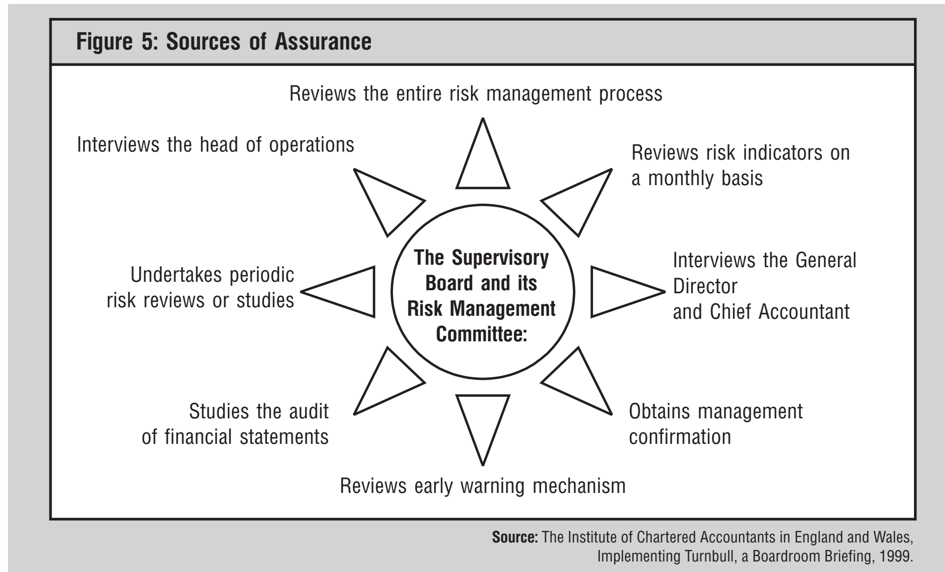

Source: The Institute of Chartered Accountants in England and Wales, Implementing Turnbull, a Boardroom Briefing, 1999.

c) Specifying Additional Documents that Must Be Kept by the Company

The company must keep certain documents such as the founders' agreement, charter, by-laws, and annual report. Both the Supervisory Board and other governing bodies have the authority to specify additional documents that must be kept by the company.[58]

➜ *For more information on the annual report, see Part IV, Chapter 13, Section C.4 and Part VI, Annex 29.*

B. The Election and Dismissal of Directors

1. The Election and Term of Directors

The GMS elects directors[59] for a term that starts from the moment that they are elected until the next AGM.[60] If a new AGM is not held within the period pro-

[58] LJSC, Article 89, Clause 1.

[59] LJSC, Article 48, Clause 1, Section 4.

[60] LJSC, Article 47, Clause 1, Paragraph 3. See also: LJSC, Article 66, Clause 1, Paragraph 1.

vided for by the Company Law, i.e. from 1 March to 30 June, the authority of directors terminates automatically, except for their authority to prepare, convene, and conduct the AGM.[61]

There are no limitations as to how many times a directors can be re-elected.[62]

Best Practices: Companies can maintain their vitality and ability to adapt to new challenges by changing the composition of their Supervisory Board. Non-executive directors may indeed lose some of their (independent) edge if they remain on a Board too long. A company may wish to impose term-limits, either for the entire Supervisory Board or a certain percentage, to keep its members focused. Either way, reappointment should not be automatic, but a conscious decision by the shareholder(s) and the director concerned.

In accordance with French law, for example, a director's mandate may not exceed six years unless the GMS decides to renew this mandate, and directors older than 70 years may not exceed one-third of board membership. In this respect, the Hellebuyk Commission recommends that directors' mandates not exceed four years and the number of directors over 65 years not exceed one-third of the board membership.[63] The French Corporate Governance Code (Vienot II) in turn provides that the duration of a directors' term of office, set by the by-laws, should not exceed a maximum of four years, in order to enable shareholders to rule upon their appointment with sufficient frequency.[64]

2. The Nomination of Candidates for the Supervisory Board

A shareholder (or a group of shareholders) owning at least 2% of voting shares has the right to nominate candidates for the Supervisory Board.

➜ *The procedure for nominating candidates for the Supervisory Board is discussed at great length in Part III, Chapter 8, Section B.1.*

[61] LJSC, Article 66, Clause 1, Paragraph 1.

[62] LJSC, Article 66, Clause 1, Paragraph 2.

[63] AFG ASFFI (Association Francaise de la Gestion Financiere). Hellebuyck Commission Recommendations on Corporate Governance, § II.D.4 (June 29, 1998). See also: http://www2.eycom.ch/corporate-governance/reference/pdfs/8/en.pdf.

[64] Report of the Committee on Corporate Governance ("the Vienot II Report"), July 1999. See also: http://www2.eycom.ch/corporate-governance/reference/pdfs/11/en.pdf.

3. Information About Supervisory Board Nominees

Information about Supervisory Board nominees must be submitted to persons entitled to participate in the GMS before the Meeting.[65] The Company Law itself does not specify what information must be disseminated. It permits the charter to specify the required information.[66]

Best Practices: Shareholders should receive sufficient information to determine the ability of Supervisory Board nominees to fulfill their duties and, if applicable, to ascertain their independence. Some useful items of information include:[67]

- The identity of the candidate;
- The identity of the shareholder (or the group of shareholders) that nominated the candidate;
- The age and educational background of the candidate;
- The positions held by the candidate during the last five years;
- The positions held by the candidate at the moment of his nomination;
- The nature of the relationship the candidate has with the company;
- Other Supervisory Board memberships or official positions held by the candidate;
- Other nominations of the candidate for a position on the Supervisory Board or official positions;
- The candidate's relationship with affiliated persons of the company;
- The candidate's relationship with major business partners of the company;
- Information related to the financial status of the candidate, and other circumstances that may affect the duties and independence of the candidate as a Board member; and
- The refusal of the candidate to respond to an information request of the company.

➜ *For information on the timeline for the disclosure of this information, see Part III, Chapter 8, Section B.4.*

[65] LJSC, Article 52, Clause 3.

[66] LJSC, Article 53, Clause 4.

[67] FCSM Code, Chapter 3, Section 2.3.1.

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4. The Election of Directors

All directors must be elected with cumulative voting.[68] Cumulative voting is a system that helps minority shareholders pool their votes to elect a representative for the Supervisory Board.

The election of directors cannot be done if a GMS is held by written consent.[69]

a) How Cumulative Voting Works

Cumulative voting works as follows:

- Candidates for the Supervisory Board are voted on collectively, i.e. as a group;
- Each shareholder has a maximum number of votes equal to the number of directors that must be elected (according to the charter or a decision of the GMS) multiplied by the number of voting shares held;
- Shareholders can allocate their votes to one candidate or divide them among several candidates as they please;
- The top X candidates with the most votes are considered elected, whereby X equals the number of Supervisory Board members to be elected as specified by the charter or the decision of the GMS.

Mini-Case 1: The following mini-case illustrates how shareholders, in particular minority shareholders, can calculate the minimum number of votes required to elect one Supervisory Board member. Once they know this, it will help them organize their collective action to put their representative on the Supervisory Board.

In this case, a company has 2,500 minority shareholders holding a total of 3,000 (or 20% of) voting shares, and one majority shareholder holding a total of 12,000 (or 80% of) voting shares. The charter states that the Supervisory Board has nine members. The 2,500 minority shareholders hold 27,000 votes (3,000 shares × 9 votes) and the majority shareholder has 108,000 votes (12,000 shares × 9 votes). The nine candidates that receive the most votes are elected to the Supervisory Board.

[68] LJSC, Article 66, Clause 4, Paragraph 1.

[69] LJSC, Article 50, Clause 2.

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A formula can be used to calculate a minimum number of votes to elect one director:

$$\frac{nS}{D + 1} + 1 = \frac{9 \times 15{,}000}{9 + 1} + 1 = 13{,}501 \text{ shares}$$

where D — the number of directors to be elected, S — the number of outstanding voting shares and n — the total number of directors the majority shareholder wants to elect ($n = 9$ directors in this example).

For this formula to work, shareholders must know the number of voting shares the company has in total (S), how many directors must be elected (D), and how many candidates they want to elect to the Supervisory Board.
The formula indicates that shareholders must have 13,501 votes to ensure that one director is elected. Minority shareholders in this example hold 27,000 votes which will enable them to elect at least one director, should they vote collectively.

b) Cumulative Voting and Collective Action

Cumulative voting increases the chance that minority shareholders elect a representative to the Supervisory Board. In order to be effective, minority shareholders must organize themselves to vote. For this, they must:

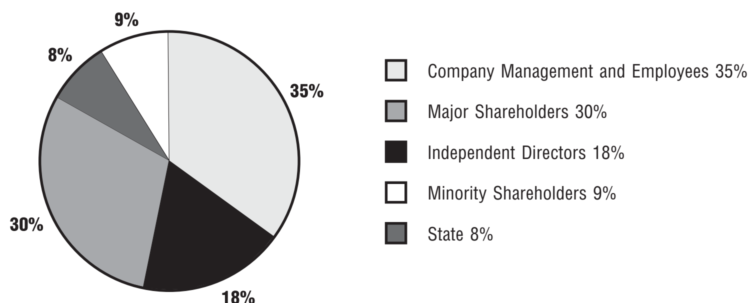
- Have the resources and skills to campaign for candidates;
- Make use of the shareholder list to contact other shareholders; and
- Be able to use cumulative voting strategically.

Mini-case 1 above illustrates the importance of collective action and voting strategy.

Company Practices in Russia: Representatives of major shareholders (35%), management and employees (30%) are the most common types of directors, as depicted in Figure 6. Independent directors (18%) and minority shareholder representatives (9%) still constitute a minority on most Supervisory Boards. A positive correlation exists between the number of shareholders in a company and the number of representatives of majority shareholders on the Supervisory Board. Hence, Supervisory Boards of large companies with many shareholders tend to include more representatives of large shareholders.[70]

[70] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.2.1, page 25, August 2003 (see www.ifc.org/rcgp).

Figure 6: The Structure of the Average Russian Supervisory Board



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

c) Cumulative Voting and Fractional Shares

Fractional shares also count when Supervisory Board members are elected. Fractional votes may not be further divided. Fractional votes may only be cast for one candidate.[71] The following mini-case shows how this rule works in practice.

> **Mini-Case 2:** Shareholder A has 5.1 voting shares. During the GMS, the shareholders are to elect nine Supervisory Board members through cumulative voting. Shareholder A is able to cast 45.9 votes (5.1 × 9). In this case, Shareholder A will cast the 45 votes as desired. Shareholder A must cast the remaining 0.9 votes for one candidate and cannot divide the fraction (0.9) into smaller fractions (for example, 0.4 to Supervisory Board candidate B and 0.5 to Supervisory Board candidate C).

d) Relationship Between the Number of Directors and the Effectiveness of Cumulative Voting

There is a direct relationship between the effectiveness of cumulative voting and the number of directors: the higher the number of directors to be elected, the greater the opportunity for minority shareholders to elect a representative to the Supervisory Board.

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[71] FCSM, Regulation No. 17/ps, on Additional Requirements to the Procedure of Preparing, Calling and Conducting the General Meeting of Shareholders, 31 May 2002, Section 2.14.

The Company Law requires that a company with less than 1,000 shareholders with voting rights elect a minimum of five Supervisory Board members.[72] Thus, a shareholder (or a group of shareholders) holding roughly 16.7% of the total number of voting shares could elect one director.[73]

A company with more than 1,000 shareholders with voting rights must have at least seven Supervisory Board members.[74] Thus, a shareholder (or a group of shareholders) holding roughly 12.5% of the total number of voting shares could elect one director.

A company with more than 10,000 shareholders with voting rights must have at least nine Supervisory Board members.[75] In this case, a shareholder (or a group of shareholders) holding a mere 10% of voting shares can secure one position on the Supervisory Board.

5. The Election of Drectors When Lacking a Quorum

Commonly, if the number of directors becomes less than the quorum, the Supervisory Board no longer can make valid decisions. It must subsequently organize an EGM to elect a new Supervisory Board. This should be done as soon as possible to have a Supervisory Board that is able to make valid decisions.[76]

➜ *For more information on the Supervisory Board's role in preparing for the EGM, see Part III, Chapter 8, Section D.*

6. The Dismissal of Directors

In the ordinary course of business, directors are elected at every AGM. Only the GMS can dismiss directors before the end of their term.[77] Since the Supervisory Board is elected with cumulative voting, the GMS can only terminate the authority of all directors collectively, not of individual members.[78] Such a GMS will in practice be an EGM.

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[72] LJSC, Article 66, Clause 3, Paragraph 1.

[73] Using the figures in the mini-case in section B.6.a) then $((1 \times 15{,}000)/5+1))+1 = 2{,}501$ shares. $(2{,}501/15{,}000) \times 100\% = 16.7\%$

[74] LJSC, Article 66, Clause 3, Paragraph 2.

[75] LJSC, Article 66, Clause 3, Paragraph 2.

[76] LJSC, Article 68, Clause 2.

[77] LJSC, Article 66, Clause 1, Paragraph 3; Article 48, Clause 1, Paragraph 4.

[78] LJSC, Article 66, Clause 1, Paragraph 3.

Best Practices: The Company Law does not specify the grounds for dismissing Supervisory Board members. Grounds may include providing false information to the company as a candidate for the Supervisory Board, willful neglect of Supervisory Board responsibilities, or conviction of a criminal act.

C. The Composition of the Supervisory Board

1. The Number of Directors

The total number of directors must be fixed in the charter or by decision of the GMS.[79] The Company Law provides for the following minimum number of directors depending on the number of shareholders:[80]

- At least five directors for companies with 1,000 and fewer shareholders with voting rights;
- At least seven directors for companies with more than 1,000 shareholders with voting rights; and
- At least nine directors for companies with more than 10,000 shareholders with voting rights.

The charter or decision of the GMS can, however, provide for a greater number of directors than the minimum number legally required.

Best Practices: Companies should choose a Supervisory Board size that will enable it to:[81]

- Hold productive and constructive discussions;
- Make prompt and rational decisions; and
- Efficiently organize the work of its committees, if these are established.

[79] LJSC, Article 66, Clause 3, Paragraph 1.

[80] LJSC, Article 66, Clause 3, Paragraphs 1 and 2.

[81] FCSM Code, Chapter 3, Section 2.1.4.

The number of directors should be guided by legal requirements, and the specific needs of the company and its shareholders. Most companies in Russia tend to have between six and ten directors.[82]

Having either too few or too many directors can be a problem for effective decision-making. A small Supervisory Board may not allow the company to benefit from an appropriate mix-of-skills and breadth of experience; a larger Supervisory Board is typically more difficult to manage, and can make consensus building time-consuming and difficult. The challenge in selecting the correct Supervisory Board size is striking an appropriate balance.

2. Who Can Be a Director

There are legal requirements of eligibility for directors:

- Only individuals with "full dispositive capacity" can be directors. Directors should have the capacity to acquire and exercise civil law rights by their actions, be able to create civil law obligations, and fulfill these rights and obligations;[83]
- A legal entity cannot be a director, although an individual who happens to be a representative of a legal entity can be elected to the Supervisory Board. In this case, the individual elected to the Supervisory Board may only serve in his capacity as a director and not as a representative of the legal entity, i.e. he must act in the interest of the company on whose Supervisory Board he is sitting and not of the company he is representing;[84]

➜ *For more information on the fiduciary duties of a director, see Section F.2 in this Chapter.*

- Revision Commission members cannot be directors;[85]
- Counting Commission members cannot be directors;[86] and

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[82] FCSM-ISMM-INVAS Survey; 2002 (see www.rid.ru).

[83] Civil Code (CC), Article 21.

[84] LJSC, Article 66, Clause 2, Paragraph 1.

[85] LJSC, Article 85, Clause 6 Paragraph 1.

[86] LJSC, Article 56, Clause 2.

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- An Executive Board member or the General Director of Company A can only be a director of Company B after the Supervisory Board of Company A has given its consent.[87]

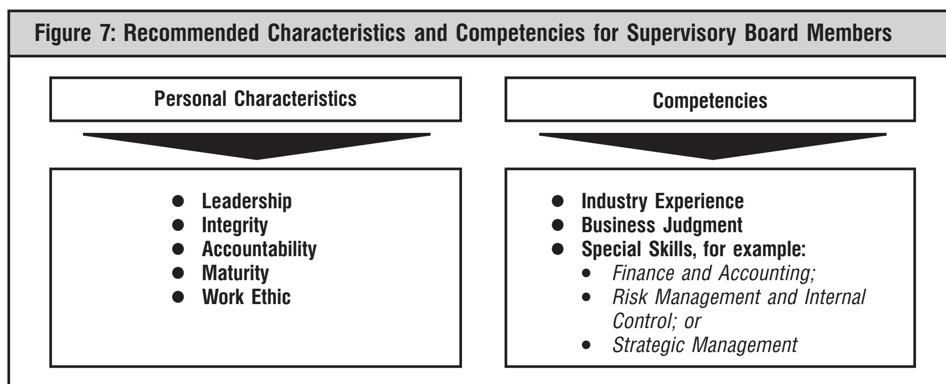
Best Practices: To avoid conflicts of interest, individuals should not be elected to the company's Supervisory Board when they are:[88]

- A director of a competing company;
- A manager of a competing company; or
- An employee of a competing company.

Nominees for the Supervisory Board should also not be related to suppliers, affiliated persons, as well as employees of the independent External Auditor.

3. Qualifications of Directors

Directors should possess the necessary skills and experience to contribute to the work of the Supervisory Board. Figure 7 illustrates the personal characteristics and competencies required for this task.



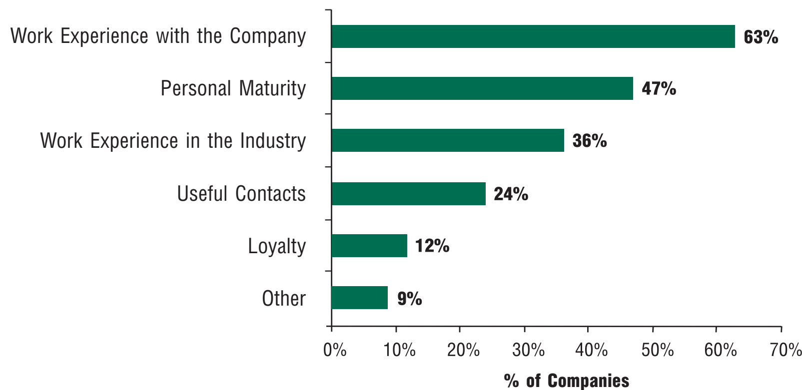
Source: IFC, March 2004

[87] LJSC, Article 69, Clause 3.

[88] FCSM Code, Chapter 3, Section 2.1.3.

Company Practices in Russia: As indicated in Figure 8, Russian companies feel that work experience within the company and the industry, as well as personal maturity are important criteria when electing directors. Other popular criteria include contacts and loyalty to the company. On the other hand, criteria such as independence, expertise, and leadership are not mentioned.[89] It can thus be inferred that the benefits of independent directors are not fully understood by Russian companies.

Figure 8: Main Criteria Used in Electing Supervisory Board Members



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

There are no legal requirements with regard to the qualification criteria of directors. As a consequence, such criteria need to be specified elsewhere. For example, companies may find useful to include qualifications in their internal company documents, as described in the following box.

Best Practices: The charter should set forth the qualification criteria of directors.[90] Directors should have the following qualifications:

- The trust of shareholders, other directors, managers, and employees of the company;
- The ability to relate to the interests of all stakeholders and make well-reasoned decisions;
- The professional expertise and education needed to be effective;

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[89] IFC Survey on Corporate Governance Practices in Russia's regions, Section 2.2.1, page 25, August 2003 (see www.ifc.org/rcgp).

[90] FCSM Code, Chapter 3, Section 2.1.3.

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- International business experience, knowledge of national issues and trends, knowledge of the market, products, and competitors; and
- The ability to translate knowledge and experience into solutions.

It may, however, be difficult for the company to determine whether a potential director possesses these qualifications. Moreover, a brief description of such qualifications in the company's charter may lead to ambiguity and thus be of little use. Instead, companies may wish to include the above criteria in their by-laws or other internal documents. Indeed, many companies in the U.S. use corporate governance guidelines for this purpose.

Shareholders should be informed of the directors' qualifications, and the list of candidates for the Supervisory Board should indicate whether, at the time of election, the candidate is or will be:[91]

- The General Director;
- An Executive Board member;
- An officer or employee of the company; and
- Able to meet the qualifications of an independent director.

The background of candidates for the Supervisory Board should be checked for a criminal record and for past administrative offences that are not *de minimis* in nature. Both are likely to preclude the membership of such candidates on the Supervisory Board as the FCSM Code calls for directors with impeccable character.[92]

4. Categories of Directors

International practice and domestic law distinguish between different categories of directors according to the degree to which such directors are involved in the affairs of (or are related to) the company. The three categories are executive, non-executive, and independent directors.

Company Practices in Russia: Many Russian companies are controlled by a single shareholder or a group of shareholders (often the General Director and/or the Chairman) who are well informed about the affairs of the company and able to closely monitor the company's management. 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.

A survey of companies in Russia's regions found that only 18% of companies follow the FCSM Code's recommendations that independent directors make up at least

[91] FCSM Code, Chapter 3, Section 2.3.3.

[92] FCSM Code, Chapter 3, Section 2.1.1.

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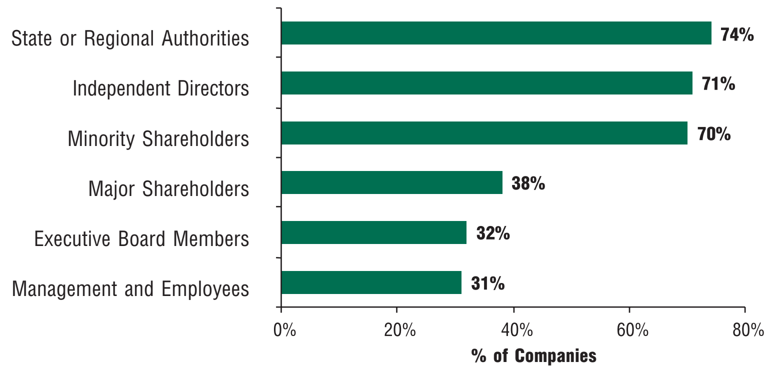
¼ of the Supervisory Board, and no less than three people (see Figure 6 above). Further, only 29% of companies have any independent directors (Figure 9).[93] Minority shareholders are also poorly represented, with 70% of the surveyed companies having no minority shareholder representative on their Supervisory Board.

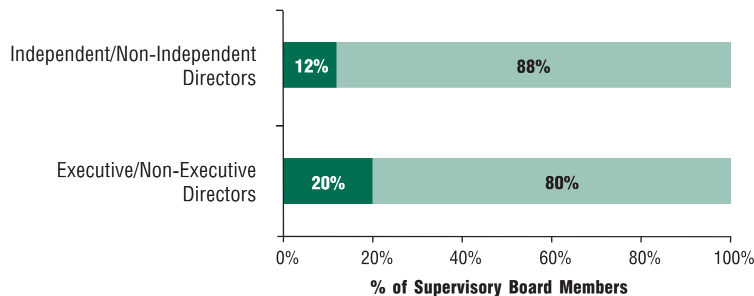
Figure 9: Companies that Do Not Have Certain Categories of Directors



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

Figure 10 shows that among Supervisory Boards that have both executive and non-executive members, the overall ratio of executives to non-executives is one to four.[94] The ratio of independent to non-independent directors, at one to nine, leaves much room for improvement on the average Russian Supervisory Board.

Figure 10: Ratio of Different Categories of Directors



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

[93] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.2.1, page 25, August 2003 (see www.ifc.org/rcgp).

[94] IFC Survey on Corporate Governance Practices in Russia's regions, Section 2.2.1, page 21, August 2003 (see www.ifc.org/rcgp).

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a) Executive Directors

Executive directors can be defined as those that also hold an executive position in the company, namely that of:

- The General Director;
- An Executive Board member; or
- A manager of the company who is not an Executive Board member.

The Company Law does not refer to executive directors as a general category; it does, however, limit the number of Executive Board members that can be Supervisory Board members. Executive Board members can occupy a maximum of 1/4 of the total number of Supervisory Board seats.[95]

Best Practices: Many Russian companies have Supervisory Board dominated by executive directors. To circumvent the above-mentioned legal provision, stating that Executive Board members can occupy a maximum of 1/4 of the total number of Supervisory Board seats, many Russian companies simply choose not to create an (or disband an already existing) Executive Board. However, Russian companies wishing to adhere to good corporate governance practices should not follow the letter but rather the spirit of the law, and limit the number of executives, rather than Executive Board members, to 1/4 of to total number of directors.

Further, the General Director cannot serve as the Chairman of the Supervisory Board at the same time (in international practice, so-called "CEO-duality").[96]

Executive directors are, by definition, not independent.

b) Non-Executive Directors

Non-executive directors are Supervisory Board members that do not hold an executive position in the company. Effective non-executive directors should have the following personal attributes:

[95] LJSC, Article 66, Clause 2.

[96] LJSC, Article 66, Clause 2.

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- Integrity and high ethical standards;
- Sound judgment;
- The ability and willingness to challenge and probe; and
- Strong interpersonal skills.

Best Practices: Most international and national codes of corporate governance recommend that (Supervisory) Boards be composed of a majority of non-executive directors who contribute:

- An outside perspective and greater impartiality in their judgments;
- Additional external experience and knowledge; and
- Useful contacts.

In Germany, for example, no more than two former members of the Executive Board or *Vorstand* may be members of the Supervisory Board so as to ensure the Supervisory Board's independent oversight capability.[97]

In most EU countries, non-executive directors normally exercise oversight of the financial and strategic decision-making functions of the company. Apart from these, there are three areas in need of disinterested monitoring by non-executive directors:[98]

- Nomination of directors;
- Remuneration of senior managers and directors; and
- Internal and external audit.

In the U.K., the Higgs report groups the role of the non-executive director around four issues:[99]

1. **Strategy:** Non-executive directors should constructively challenge and contribute to the development of strategy.
2. **Performance:** Non-executive directors should scrutinize the performance of management in meeting agreed upon goals and objectives, and monitor the reporting of performance.

[97] The German Corporate Governance Code, 5.4.2. See also: www.ecgi.org/codes/country_documents/germany/code_200305_en.pdf.

[98] Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, November 2002, page 60. See also: europa.eu.int/comm/internal_market/en/company/company/modern/consult/report_en.pdf.

[99] Derek Higgs, Review of the role and effectiveness of non-executive directors, January 2003. See also: www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf.

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3. **Risk:** Non-executive directors should satisfy themselves that financial information is accurate, and that financial controls and systems of risk management are robust and defensible.
4. **People:** Non-executive directors are responsible for determining appropriate levels of remuneration for executive directors, have a prime role in appointing, and where necessary removing, senior management, and in succession planning.

The Company Law refers to non-executive directors in the context of restricting the number of executive directors that may sit on the Supervisory Board. Table 2 summarizes the relevant legal provisions concerning executive and non-executive directors' functions.

Table 2: Restrictions on Executive and Non-Executive Directors[100]	
Can a director be a member of the Executive Board?	Yes, but Executive Board members cannot occupy more than 25% of Supervisory Board seats.
Can a director be a General Director?	Yes, unless prohibited by the charter.
Can the Chairman of the Supervisory Board be the General Director?	No.
Can the Chairman of the Supervisory Board be a member of the Executive Board other than the General Director?	Yes, unless prohibited by the charter.

Non-executive directors may, depending on their ties to the company, be independent or non-independent.

c) Independent Directors

Russian law does not define the concept of independent directors. The Company Law does, however, refer to independent directors under specific circumstances to determine the position of individuals engaged in related party transactions and to prevent possible conflicts of interests. For these purposes, the

[100] LJSC, Article 66, Clause 2, Paragraph 2.

requirements for the "independence" of directors are wider than those for a non-executive position. In this respect, an independent director is defined as an individual who has not been in any of the following positions at the time of the approval of a business transaction, or during one year immediately preceding the approval of such a transaction:[101]

- The General Director, the External Manager, an Executive Board member or a member of the governing bodies (Supervisory Board, General Director and Executive Board) of the External Manager; or
- A person whose spouse, parents, children, brothers, and sisters by one or both parents are the External Manager or hold a position in the governing bodies of the External Manager; or
- A person whose adoptive parents or adopted children are the External Manager or hold a position in the governing bodies or the External Manager; or
- An affiliated person other than a director of the company.

➜ *For more information on affiliated persons, see Part III, Chapter 12, Section B.1.*

Best Practices: Independent directors can make a substantial contribution to important decisions of the company, especially in evaluating executive performance, setting executive and director remuneration, reviewing financial statements, and in resolving corporate conflicts.[102] Independent directors give investors additional confidence that the Supervisory Board's deliberations will be free of obvious bias. Companies are advised to disclose information about independent directors in the annual report.[103]

In contrast to the Company Law, the FCSM Code discusses the concept of independent directors and defines which Supervisory Board members can be defined as independent. More specifically, the FCSM Code disqualifies directors from being independent if they answer "YES" to one or more of the following questions in Table 3:

[101] LJSC, Article 83, Clause 3, Paragraph 2.

[102] FCSM Code, Chapter 3, Section 2.2.2.

[103] FCSM Code, Chapter 3, Section 2.2.5.

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Table 3: Are Directors on Your Supervisory Board Independent According to the FCSM Code?		
	Yes	No
Is the director an officer or an employee of the company, or the External Manager of the company? Has the director been an officer or an employee of the External Manager of the company over the last three years?	☐	☐
Is the director an officer of another company in which any of the officers of the company is a member of the Nominations and Remuneration Committee of the Supervisory Board of that company?	☐	☐
Is the director an affiliated person of an officer of the company, of the External Manager or of an officer of the External Manager of the company?	☐	☐
Is the director an affiliated person of the company or an affiliated person of persons affiliated with the company?	☐	☐
Is the director a party to a contract with the company whereby the director could acquire property of the company (or receive money) with a value of 10% or more of the total annual income of the said director, excluding the remuneration he receives for his work as a director?	☐	☐
Is the director a major business partner of the company (i.e., a business partner involved in transactions with the company where the total annual amount of transactions is 10% or more of the book value of company assets)?	☐	☐
Is the director a representative of the state?	☐	☐
Has the director been a Supervisory Board member of the company during the last seven years?	☐	☐

If a director ceases to be independent, the director should immediately notify the Supervisory Board with an explanation of why the criteria of independence as specified in the FCSM Code no longer apply.[104] The Supervisory Board is then advised to:

- Notify shareholders that the director is no longer independent;
- Call an EGM to elect new Supervisory Board if the number of independent directors is below the minimum that is recommended by the FCSM Code;[105] and
- Disclose information about independent directors in the annual report of the company, giving shareholders the opportunity to verify any changes in the status of independent directors.[106]

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[104] FCSM Code, Chapter 3, Section 2.2.4.
[105] FCSM Code, Chapter 3, Section 2.2.4.
[106] FCSM Code, Chapter 3, Section 2.2.5.

In any event, independent directors should refrain from actions that may compromise their independent status.

The minimum number of independent directors should be at least $^1/_4$ of the total Supervisory Board seats and no less than three.[107] This should enable independent directors to influence the decision-making process of the Supervisory Board and introduce a wider spectrum of opinions to Supervisory Board deliberations. While these minima are useful benchmarks, they are by no means sufficient to ensure an absence of bias. The circumstances of each Supervisory Board are likely to be different. In some cases, the minimum may be sufficient for balanced deliberation; in others, a larger number of independent and assertive directors may be necessary to counterbalance a dominant General Director.

Other international and national codes of corporate governance have stricter definitions for independent directors. In the U.K. for example, a non-executive director is considered independent when the Board of Directors determines that the director is independent in character and judgment, and there are no relationships or circumstances which could affect, or appear to affect, the director's judgment. Such relationships and circumstances would include those, in which the director:[108]

- Is a former employee of the company or group until five years after employment (or any other material connection) has ended;
- Has, or has had, within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director, or senior employee of a body that has had such a relationship with the company;
- Has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance related pay scheme, or is a member of the company's pension scheme;
- Has close family ties with any of the company's advisers, directors, or senior employees;
- Holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- Represents a significant shareholder; or
- Has served on the Supervisory Board for more than 10 years.

[107] FCSM Code, Chapter 3, Section 2.2.3.

[108] The Combined Code on Corporate Governance, July 2003, Section 1, A.3.1. See also: www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf.

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The large number of definitions with their detailed qualifications may give rise to confusion. In reality, understanding and defining independence need not be complex. The Council of Institutional Investors (CII), a grouping of some of the world's largest institutional investors, defines an independent director plainly in the following way: "Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation." This cuts to the heart of the matter. For those interested in learning how to apply this simple definition in practice, the CII also lists specific circumstances that compromise independence.[109]

Finally, it should be noted that director independence is not a panacea. The New York Stock Exchange is a telling example. In 2003, the exchange was enveloped in a scandal over the excessive compensation of its chief executive officer, despite the fact that compensation levels had been approved by a committee staffed and chaired by independent directors.

➜ *For the IFC's definition on independence, see Part VI, Annex 18.*

D. The Structure and Committees of the Supervisory Board

1. Chairman

The Supervisory Board members elect their Chairman by a simple majority vote of all directors if the charter does not provide otherwise.[110] The Supervisory Board may re-elect its Chairman at any time. Another Supervisory Board member may substitute for the Chairman in his absence.[111] The Chairman must be a Supervisory Board member and cannot be the General Director.[112]

Best Practices: The ability of the Chairman to properly discharge his duties depends on his being vested with sufficient and appropriate powers, and on his personal and professional qualifications. The Chairman should have an out-

[109] For more information on the CII and their definition of director independence (in English), see: http://www.cii.org/independent_director.asp.

[110] LJSC, Article 67, Clause 1.

[111] LJSC, Article 67, Clause 3.

[112] LJSC, Article 66, Clause 2, Paragraph 2.

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standing professional reputation and should be of the highest integrity, be committed to the interests of the company, and enjoy the trust of shareholders and the other directors.[113]

There should be a clear division of responsibilities at the head of the company between the running of the Supervisory Board and the executive responsibility for the running of the company's day-to-day operations — both on paper, as required by law, and in actual practice. Companies should define the authority of the Chairman, as well as that of the General Director, in as much detail as possible in the by-laws or other internal documents.[114]

The Chairman has the authority to:[115]

- Prepare, organize, and preside over Supervisory Board meetings;
- Preside over the GMS when the charter does not provide otherwise;
- Enter into contracts with the General Director, Executive Board members, and the External Manager;[116] and
- Perform any other duties as specified in the charter and by-laws.

Best Practices: The Chairman's other duties, or responsibilities, should be defined in the by-laws for the Supervisory Board. In addition, the company may wish to draft a position description, or terms of reference, which could contain the following elements:[117]

The Chairman:

- Provides leadership and ensures for the Supervisory Board's effectiveness;
- Establishes, implements, and reviews procedures that govern the Supervisory Board's work;

[113] FCSM Code, Chapter 3, Section 4.1.1.

[114] FCSM Code, Chapter 3, Section 4.1.1.

[115] LJSC, Article 67, Clause 2.

[116] LJSC, Article 69, Clause 3, Paragraph 2.

[117] These model terms of reference contain elements from the "Review of the Role and Effectiveness of Non-executive Directors," by Derek Higgs, January 2003; and the Report of the NACD Blue Ribbon Commission on Director Professionalism, Appendix B.

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- Schedules a Supervisory Board meeting calendar and coordinates it with the Board's committee chairs;
- Organizes and presents meeting agendas, and ensures that all directors receive appropriate information on a timely basis;
- Periodically interacts with the General Director, and acts as a liaison between the Supervisory Board and executives;
- Ensures for accurate, timely, and clear information to and from the other directors;
- Ensures for effective communication with shareholders;
- Arranges regular evaluations of the Supervisory Board's performance, as well as of its committees and individual directors;
- Facilitates the effective contribution of non-executive and/or independent directors, and enables constructive relations between executive and non-executive directors; and
- Carries out other duties as requested by the GMS and the Supervisory Board as a whole, depending on need and circumstance.

2. Supervisory Board Committees

As the business environment continues to become more complex, the demands on and responsibilities of the Supervisory Board and its members continue to grow. Supervisory Board committees are widely considered a key tool for Supervisory Boards to effectively deal with such challenge. More specifically, committees:

- Permit the Supervisory Board to handle a greater number of complex issues in a more efficient manner, by allowing specialists to focus on specific issues and provide detailed analysis and recommendations back to the Board;
- Allow the Supervisory Board to develop subject-specific expertise on the company's operations, most notably on financial reporting, risk, and internal control; and
- Enhance the objectivity and independence of the Supervisory Board's judgment, insulating it from potential undue influence of managers and controlling shareholders.

It is of crucial importance that committees are understood to be part of the Supervisory Board. It is the Supervisory Board that establishes committees, sets their terms of reference through committee by-laws, appoints their members, and turns their recommendations into actions. It is of particular importance that Board committees make recommendations to the Supervisory Board and not make decisions on its behalf.

To streamline the operations of committees, the Supervisory Board should approve by-laws for each Supervisory Board committee.[118]

Company Practices in Russia: Of the companies that participated in the IFC's regional survey, only 3.3% have specialized Supervisory Board committees. Of these, not a single one is chaired by an independent director. The prevalence of Supervisory Board committees is low regardless of the Supervisory Board's size.[119]

a) Types of Committees

The FCSM Code recommends that companies establish a number of committees. However, caution is called for. A large number of committees can be hard to manage and may lead to a fragmentation of the Supervisory Board. It is advisable to establish committees as the need arises, starting with the most critical ones, and then establishing others as experience is gained. The Supervisory Board may establish either permanent or *ad-hoc* Board committees. The most important committee from the shareholder perspective is the Audit Committee. Some of the committees that a company should consider establishing are described in Table 4.

[118] FCSM Code, Chapter 3, Section 4.7.2.

[119] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.2.1, page 25, August 2003 (see www.ifc.org/rcgp).

Table 4: Different Types of Committees		
	Functions	**Recommendations for the Committee's Composition**
Audit Committee[120]	• Develops recommendations for the Supervisory Board on the selection of the External Auditor; • Interacts with the company's External Auditor and Revision Commission; • Supervises the company's financial and business operations, and the implementation of the financial and business plan; • Monitors the Internal Audit Function; • Evaluates internal control procedures; • Develops internal control and risk management procedures; and • Develops recommendations for the Supervisory Board's approval of non-standard operations.[121] ➜ *For more information on the Audit Committee, see Part IV, Chapter 14, Section C, and Annex 7.*	The Audit Committee should be composed entirely of independent directors. If this is not possible, the Audit Committee should be chaired by an independent director and be composed solely of non-executive directors. The charter (or by-laws) should set forth the qualifications of Committee members. In particular, Audit Committee members need to be financially literate, and understand accounting and financial reporting.[122]
Strategic Planning and Finance Committee[123]	• Defines strategy and objectives, as well as key performance indicators; • Determines operational priorities; • Develops dividend policy; and • Evaluates the long-term productivity of the company's operations. ➜ *For a model by-law for the Supervisory Board's Strategic Planning and Finance Committee, see Part VI, Annex 10.*	(No specific recommendation made by the FCSM Code.) Members of the Committee need experience in the industry in which the company is active. The Committee will likely benefit from members with other areas of expertise such as finance and operations.
Ethics Committee[124]	• Ensures that the company complies with ethical standards and contributes to the creation of an atmosphere of trust within the company. • Detects and prevents violations by the company of legislation and ethical standards. ➜ *For a model Code of Ethics, see Part VI, Annex 5.*	(No specific recommendation made by the FCSM Code.) Members of the Committee must be of the highest integrity, enjoy the trust of all shareholders, and be knowledgeable on legal and ethical standards.

[120] FCSM Code, Chapter 3, Sections 4.8–4.12.

[121] FCSM Code, Chapter 3, Section 4.9; Chapter 8, Sections 1.1.2, Paragraphs 2, 1.2, 1.4, 2.2, and 2.3.

[122] FCSM Code, Chapter 8, Section 1.3.2.

[123] FCSM Code, Chapter 3, Section 4.8.

[124] FCSM Code, Chapter 3, Section 4.12.

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Table 4: Different Types of Committees

	Functions	Recommendations for the Committee's Composition
Nominations and Remuneration Committee[125]	• Defines the qualifications of Supervisory Board members; • Develops the company's remuneration policy, specifies basic principles and criteria for determining the amount of remuneration payable to: – Supervisory Board members; – The General Director; – Executive Board members; and – Heads of major divisions of the company. • Develops criteria for the performance evaluation of these persons; • Performs periodic evaluations of the General Director and Executive Board members; • Defines benefits available to these persons (including life insurance, health insurance, and non-governmental pension benefits); • Determines qualifications of candidates for positions in executive bodies and heads of major divisions of the company; • Prepares the terms and conditions of employment contracts between the company and the General Director and Executive Board members; • Conducts preliminary assessments of candidates for the positions of General Director and Executive Board members; • Prepares recommendations for the Supervisory Board with respect to the reappointment of the General Director and Executive Board members; and • Considers the company's personnel policy, including matters related to wages and salaries. ➜ *For a model by-law for the Supervisory Board's Nominations and Remuneration Committee, see Part VI, Annex 9.*	The Nominations and Remuneration Committee should be composed of independent directors. If this is not possible, the Committee should be chaired by an independent director and be composed of non-executive directors.[126]
Corporate Conflicts Resolution Committee[127]	• Ensures that shareholder rights are appropriately and specifically defined in the company's charter, by-laws, and company-level corporate governance code, and develops policies and procedures for the protection of these rights; • Develops and periodically conducts reviews of the company's conflict resolution policy and procedures; and • Develops recommendations for the Supervisory Board on how to effectively deal with corporate conflicts between and among the company, its shareholders, directors, and managers. ➜ *For a model by-law for the Supervisory Board's Corporate Governance Committee, see Part VI, Annex 8.*	The Corporate Conflicts Resolution Committee should be composed of independent directors. When this is not possible, an independent director should chair the Committee. Members should, at a minimum, be non-executive directors.

[125] FCSM Code, Chapter 3, Section 4.10.1.

[126] FCSM Code, Chapter 3, Section 4.10.3.

[127] FCSM Code, Chapter 10, Section 2.1.2.

b) Authority of Supervisory Board Committees

The Supervisory Board is a collective body in which:

- All members have equal rights and duties (the charter may provide that the Chairman have a decisive vote in case of a tie vote);
- All members bear joint and several liability; and
- Members act together as a body according to specific decision-making procedures.

This implies that although certain tasks can be delegated to Supervisory Board committees, the ultimate decision-making responsibility rests with the entire Supervisory Board. Committee members do not have more legal rights than any other Supervisory Board member, although they will have additional responsibilities and obligations.

c) The Composition of Supervisory Board Committees

Supervisory Board committees should only be composed of Supervisory Board members. Other parties, most notably managers, may be invited to present or elaborate on particular issues, but have observer status only, i.e. are precluded from conferring or deciding on particular issues.

Best Practices: Experienced and knowledgeable directors should staff Supervisory Board committees.[128] There needs to be a sufficient number of directors to accomplish the work at hand. Since the work of Supervisory Board committees may involve time-consuming reviews, the participation of directors in multiple Supervisory Board committees should be restricted. Supervisory Board committees may, from time to time, require the assistance of outside advisors to assist committees with their work. These advisors must, however, not receive Supervisory Board member status.

Many stock exchanges further recommend that Supervisory Board committees be composed of and/or chaired by independent directors. The listing requirements of some stock exchanges, for example the NYSE, go further and require a majority of independent directors, as well as the Audit and Nominations and Remuneration Committees to be composed solely of independent directors.

[128] FCSM Code, Chapter 3, Section 4.7.1.

d) The Role of the Chairman in Relation to Supervisory Board Committees

Best Practices: The Chairman should:[129]

- Take into account the views of directors on the need to create committees;
- Nominate directors for positions in committees; and
- Take necessary administrative measures to ensure that committees perform their tasks.

3. The Chairman of a Supervisory Board Committee

The Chairman of a committee is responsible for its effectiveness, regardless of his other duties. The committee Chairman forms an effective team, organizes productive committee meetings, and provides intellectual leadership on complex issues.

Best Practices: The Chairman of a committee plays an important role in organizing its work. Committees should be chaired by non-executive directors.[130] Ideally, these directors should also be independent. This holds particularly true for the Audit and Nominations and Remuneration Committees which, according to best corporate governance practices, are to be chaired by independent directors.

Committee chairmen should keep the Chairman of the Supervisory Board informed about their work. In addition, the committee chairmen should be present at the GMS to respond to shareholder questions.[131]

[129] FCSM Code, Chapter 3, Section 4.1.5.
[130] FCSM Code, Chapter 3, Section 4.7.3.
[131] FCSM Code, Chapter 2, Section 2.1.1.

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E. The Working Procedures of the Supervisory Board

The Supervisory Board is a governing body, which operates according to a procedure defined by the Company Law, the charter, or the by-laws.

1. The Chairman and Supervisory Board Meetings

The Chairman has the authority to:[132]

- Call, organize, and preside over Supervisory Board meetings;
- Prepare the minutes of Supervisory Board meetings;
- Cast a deciding vote at Supervisory Board meetings in case of a tie vote (if this is provided for by the charter); and
- Sign the minutes of the Supervisory Board meeting (when it is presided over by him).

Best Practices: More specifically, the Chairman facilitates the work of the Supervisory Board by:[133]

- Setting the agenda of the meetings;
- Facilitating decision-making on agenda items;
- Encouraging open discussions on issues in a friendly and constructive atmosphere;
- Providing Supervisory Board members with an opportunity to express their points of view on matters being discussed; and
- Steering the Supervisory Board towards a consensus.

In doing so, the Chairman should act with conviction and, at all times, in the best interests of the company. Moreover, the by-laws or other internal documents should impress upon the Chairman the responsibility to:[134]

- Take steps to ensure that all directors receive information required for the resolution of agenda items in a timely fashion;
- Encourage directors to freely express their opinions on agenda items and other issues;
- Openly discuss opinions of directors; and
- Initiate the drafting of the Supervisory Board's decisions.

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[132] LJSC, Article 67, Clause 3; Article 68, Clauses 3 and 4.

[133] FCSM Code, Chapter 3, Sections 4.1.2-4.1.3.

[134] FCSM Code, Chapter 3, Section 4.1.2.

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2. The Supervisory Board Meetings

The Supervisory Board must follow legal requirements in making valid decisions, or risk having them overruled by the courts upon complaints.[135]

Best Practices: Directors should ensure that Supervisory Board and committee meetings are well-organized and held on a regular basis. Directors should actively participate in Supervisory Board meetings, and each director should:

- Take part in discussions and voting;
- Participate in the work of Supervisory Board committees;
- Demand a Supervisory Board meeting to discuss matters of concern;[136] and
- Notify the Supervisory Board when they are unable to attend meetings.[137]

In addition, Supervisory Board members should have sufficient time for the performance of their functions. The Supervisory Board should develop rules to regulate the participation of its members on Supervisory Boards of other companies.[138] For example, in Australia, a chairmanship of a listed company is considered the equivalent of three directorships, and the maximum acceptable number of directorships or equivalent positions for an individual should not exceed five.[139] The general rule for directorship on several Supervisory Boards should however be based on time-constraints: if a director does not have the time, he should not take on the responsibility.

3. The First Supervisory Board Meeting

Best Practices: The first meeting of a newly elected Supervisory Board should be held no later than one month after it is elected. As a matter of convenience, the first Supervisory Board meeting can be organized to follow the GMS. The

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[135] LJSC, Article 68, Clauses 2 and 3.

[136] FCSM Code, Chapter 3, Section 3.2.2.

[137] FCSM Code, Chapter 3, Section 3.2.1.

[138] FCSM Code, Chapter 3, Section 3.2.3.

[139] Australian Certified Public Accountants, Corporate Governance Health Checks, Financial Reporting Framework — The Way Forward (www.cpaaustralia.com.au/07_information_centre/16_media_releases/2002/1_0_20020708_mr.asp).

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Chairman of the Supervisory Board is typically elected during this meeting. In addition, it is recommended that the first Supervisory Board meeting:[140]

- Define and confirm the priorities of the Supervisory Board;
- Establish committees if appropriate; and
- Elect committee chairmen.

A company may also wish to develop an induction training for new Supervisory Board members that covers, among other topics, an overview of the company's:

- Industry and sector of operation;
- Business operations;
- Current financial situation;
- Strategy;
- Business risks; and
- Key employee background and skills.

4. The Schedule of Supervisory Board Meetings

The charter or the by-laws must specify the procedures for convening and conducting Supervisory Board meetings.[141]

Best Practices: The Supervisory Board should have a working plan in addition to a schedule for meetings that includes the topics to be addressed.[142] The Supervisory Board should hold regular meetings. According to the FCSM Code, the Supervisory Board should meet every six weeks.[143] The Supervisory Board may, however, wish to hold meetings as often as deemed necessary. Here is some guidance on conducting productive and efficient Supervisory Board meetings:

- **Develop an annual calendar of meetings.** This will allow directors to slot the meetings in their agenda. Note that this calendar should serve as a guide, i.e. the Supervisory Board should hold additional meetings when warranted and, vice-versa, cancel meetings when there are no issues to be resolved.

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[140] FCSM Code, Chapter 3, Section 4.2.2.

[141] LJSC, Article 68, Clause 1.

[142] FCSM Code, Chapter 3, Section 4.2.1.

[143] FCSM Code, Chapter 3, Section 4.2.1.

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- **Set an agenda well in advance.** Directors will thus be able to properly focus on and prepare for the task at hand. The Chairman may wish to send a draft agenda in advance, allowing for comments and suggestions.
- **Place important issues at the beginning of the agenda.** Directors often have other commitments and might need to leave early. Scheduling meetings for the early, rather than latter part of the day is thus often more conducive to foster interactive discussions.

In addition to regular meetings, the Supervisory Board needs to organize a meeting to review and approve the annual report.[144] This Board meeting needs to take place at least 30 days prior to the AGM.

Company Practices in Russia: According to the latest surveys, Supervisory Boards of Russian companies meet between eight[145] and 11 times a year.[146]

5. Who Has the Right to Convene a Supervisory Board Meeting

The Chairman normally convenes regular Supervisory Board meetings. He also has the obligation to convene a Supervisory Board meeting upon the request of the following parties:[147]

- Supervisory Board members;
- The Revision Commission;
- The External Auditor;
- The General Director and the Executive Board; and
- Other persons specified by the charter.[148]

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[144] LJSC, Article 88, Clause 4.

[145] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.2.1, page 26, August 2003 (see www.ifc.org/rcgp).

[146] FCSM-ISMM-INVAS Survey (2002), see also: www.rid.ru.

[147] LJSC, Article 68, Clause 1.

[148] For example, a shareholder or a group of shareholders holding 2% or more of voting shares of the company. See FCSM Code, Chapter 3, Section 4.2.3; Chapter 3, Section 4.13.

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6. Proper Notice for Supervisory Board Meetings

Best Practices: Directors should properly prepare themselves to participate effectively in meetings.[149] They should not vote on items on which they have not been fully informed or which they do not understand. The necessary information and materials should be sent to director together with the notice of the Supervisory Board meeting sufficiently in advance of the meeting to enable each director to thoroughly review the information.[150] Two weeks can be considered sufficient. The by-laws or other internal documents should determine the form of the notice and the way materials are delivered that is most convenient and acceptable to all directors (for example by mail, telegraph, teletype, telephone, or e-mail).[151]

7. The Quorum for Supervisory Board Meetings

A quorum is the minimum number of directors that must participate in a meeting for decisions to be valid. The charter must specify the quorum, which cannot be less than one half of the number of elected directors.[152]

If the number of acting directors becomes less than the required quorum, the Supervisory Board no longer has the authority to make decisions other than to convene an EGM for the election of new directors.[153]

Best Practices: For a few very important corporate actions, the charter, by-laws, or other internal documents should establish stricter quorum requirements than those set by the Company Law. A quorum of $^2/_3$ of the total number of directors should be required to:[154]

- Approve strategic plans, and the financial and business plan;

[149] FCSM Code, Chapter 3, Section 4.5.

[150] FCSM Code, Chapter 3, Section 4.5.2.

[151] FCSM Code, Chapter 3, Section 4.5.3.

[152] LJSC, Article 68, Clause 2.

[153] LJSC, Article 68, Clause 2.

[154] FCSM Code, Chapter 3, Section 4.15.

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- Approve the company's dividend policy and recommend dividend payments;
- Submit to the GMS a proposal for the reorganization or liquidation of the company; and
- Decrease or increase the charter capital.

In addition, the quorum should be set so as to ensure that independent directors are required for the quorum to exist.[155]

8. How Directors Can Participate in Supervisory Board Meetings

Directors can participate in voting when they are:

- Physically present at the meeting;
- Participating by conference call or other means of communication (when allowed by the charter or by-laws); or
- Absent, but have presented a written opinion (when allowed by the charter or by-laws).

Best Practices: Certain items are of such importance that directors need to be physically present. These items include:[156]

- The approval of the strategic plan, and the approval of the company's financial and business plan;
- Calling the AGM, and making decisions on items related to the organization of such Meeting;
- The preliminary approval of the annual report of the company;
- Convening or refusing a request by third parties to convene an EGM;
- The election of the Chairman;
- The creation and early termination of the authority of executive bodies;
- The suspension of the General Director and the appointment of an interim General Director;
- The reorganization or liquidation of the company; and
- Increasing the charter capital and issuing shares.

[155] FCSM Code, Chapter 3, Section 4.14.

[156] FCSM Code, Chapter 3, Section 4.4.

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A director cannot delegate his right to vote at a Supervisory Board meeting to another person, including to another director.[157]

Best Practices: When participating in Supervisory Board meetings, each director should:
- Listen and understand oral presentations;
- Ask questions. This is particularly important for presentations or reports given by executives during Supervisory Board meetings, especially when these materials are presented in a complex or ambiguous manner; and
- Request supporting materials. When presented with a particular issue that does not correspond to the director's area of expertise, additional information in the form of studies, independent appraisals or opinions, and other documentation on the subject should be requested prior to the meeting.

9. The Consideration of Written Opinions (Absentee Ballots)

The charter or by-laws can specify that written opinions of directors can be considered in determining the existence of a quorum for Supervisory Board meetings, and the validity of the voting results.[158]

Best Practices: The charter, by-laws, or other internal documents should enable Supervisory Board members to make decisions by absentee vote. However, for resolutions required by the charter to be adopted by voting in person, the votes of absentees expressing their opinion in written form should not be counted for the quorum.[159] Companies should develop procedures for absentee voting, including the deadline for the delivery of voting ballots and deadline for the return of completed ballots. It should give directors enough time to receive the ballots and make decisions on agenda items.[160]

[157] LJSC, Article 68, Clause 3, Paragraph 2.

[158] LJSC, Article 68, Clause 1.

[159] FCSM Code, Chapter 3, Section 4.3.1.

[160] FCSM Code, Chapter 3, Section 4.3.2.

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10. Supervisory Board Decisions

Supervisory Board decisions must be approved by a simple majority vote unless the Company Law, the charter, and/or by-laws require a higher percentage of votes.[161]

Table 5: Decisions That Must Be Made Unanimously or by a Supermajority Vote of All Directors	
Supervisory Board decisions requiring unanimity:	**Supervisory Board decisions requiring the approval of a 3/4-majority:**
• Increasing the charter capital by issuing and placing additional shares (when the Supervisory Board has this authority).[162] • Approving an extraordinary transaction.[163] ➜ *For more information on extraordinary transactions, see Part IV, Chapter 12, Section A.*	• Suspending the powers of the General Director or the External Manager for any reason.[164] • Approving an interim General Director. • Conducting an EGM to approve the new General Director or the External Manager.[165]

How decisions on related party transactions are approved depends on the number of shareholders. More specifically:[166]

- A simple majority of directors that are not interested parties in companies with 1,000 or fewer shareholders with voting rights;
- A simple majority of independent directors that are not interested parties in companies with more than 1,000 shareholders with voting rights.

[161] LJSC, Article 68, Clause 3, Paragraph 1.

[162] LJSC, Article 28, Clause 2.

[163] LJSC, Article 79, Clause 2.

[164] If the formation of executive bodies falls within the authority of the GMS, and if the charter gives the right to approve the decision to the Supervisory Board.

[165] LJSC, Article 69, Clause 4, Paragraph 3.

[166] LJSC, Article 83, Clauses 2 and 3.

11. The Minutes of Supervisory Board Meetings

The Supervisory Board must keep minutes of its meetings.[167] Minutes must be prepared within three days after the meeting and must be kept in the company archives. At a minimum, the minutes must contain the following:

- Location and time of the meeting;
- Names of the persons who participated in the meeting;
- Agenda of the meeting;
- Agenda items and the voting results; and
- A description of Supervisory Board decisions.

The Chairman is responsible for the accuracy of the minutes and must sign them.[168]

Best Practices: As legal and regulatory requirements of directors become more onerous, minutes are an important record to show that the Supervisory Board has discharged its duty of care. Under good corporate governance practices, the minutes will include the voting of each individual director.[169] The company may also consider having each director sign the minutes.

➜ *For more information on the importance of minutes for the liability of directors, see Section F.7 of this Chapter.*

The Supervisory Board is often required to designate a secretary of the Supervisory Board to take notes and help prepare the minutes. In international practice, the Corporate Secretary often serves as the secretary of the Supervisory Board and may sign the minutes as well.

➜ *To view a model set of minutes, see Part VI, Annex 16.*

Minutes only provide a brief summary of the Supervisory Board meeting. Verbatim reports, however, contain a word-for-word account of discussions held.

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[167] LJSC, Article 68, Clause 4; Article 89, Clause 1.

[168] LJSC, Article 68, Clause 4.

[169] FCSM Code, Chapter 3, Section 4.16.1.

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Best Practices: Regardless of whether the company chooses to keep minutes and/or verbatim reports, the following documents should be preserved together with these reports:[170]

- The voting ballots; and
- The written opinions of directors who were not able to attend.

Each director should also be given a summary of the deliberations of the Supervisory Board. The company should establish a procedure which ensures that all directors will be provided with:[171]

- Copies of the minutes and/or verbatim reports; and
- Reports detailing the outcome of the voting.

This should be done within a reasonable amount of time after the meeting, but no later than the next Supervisory Board meeting.

12. The Corporate Secretary and Supervisory Board Meetings

Best Practices: The Corporate Secretary should be responsible for administrative and organizational matters with respect to preparing and conducting Supervisory Board meetings.[172] While the decision to conduct a Supervisory Board meeting is made by the Chairman, the Corporate Secretary should be responsible for handling such matters as:[173]

- Notifying all directors of Supervisory Board meetings;
- Sending voting ballots;
- Collecting completed ballots and absentee ballots;
- Ensuring compliance with the procedures for Supervisory Board meetings; and
- Keeping the minutes and verbatim reports.[174]

➜ *For more information on the Corporate Secretary, see Part II, Chapter 6.*

[170] FCSM Code, Chapter 3, Section 4.16.1.

[171] FCSM Code, Chapter 3, Section 4.16.2.

[172] FCSM Code, Chapter 5, Section 1.2.1.

[173] FCSM Code, Chapter 5, Section 1.2.2.

[174] FCSM Code, Chapter 5, Section 1.2.3.

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F. The Duties and Liabilities of Directors

Directors shall act in good faith, with diligence and due care, and in the best interests of the company.

Best Practices: In some countries, including Russia, the Supervisory Board is legally required to solely act in the interest of the company (without specifying the interest of the company towards its shareholders and/or stakeholders). Acting solely in the best interest of the company can however encourage management to entrench themselves, and shareholders (and indeed the legislator) will need to carefully consider whether to require directors to act in the best interests of shareholders as well.

Standards for the interpretation of the terms "good faith," "due diligence," and "due care," as well as standards for professional behavior, develop over time in a country's judicial system, economy, and corporate culture.[175]

The Company Law dictates that directors must act reasonably and in good faith.[176] There is also a general requirement for a person authorized to act on behalf of the company, based on law or the charter, to act "reasonably and in good faith".[177] It is important to note that when a court action is brought against an individual and there is a question of whether this individual acted reasonably and in good faith, reasonableness and good faith are presumed.[178] However, neither the Company Law nor the Civil Code defines "good faith" or "reasonableness."

Turning to other jurisdictions for guidance, for example the U.S. and U.K., the concepts of reasonableness and good faith are viewed as fundamental principles of a director's duty, notably that of care and loyalty.

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[175] When explaining these duties, the Manual refers to general provisions of the Civil Code and the Company Law on the one hand, and the FCSM Code and internationally recognized corporate governance principles on the other.

[176] LJSC, Article 71, Clause 1.

[177] CC, Article 53, Clause 3.

[178] CC, Article 10, Clause 3.

1. The Duty of Care

Supervisory Board members are responsible for exercising their rights and discharging their duties in good faith, with care, and in a professional manner.

Best Practices: A director should:[179]

- Act honestly and in good faith;
- Refrain from being passive;
- Use care and prudence to the maximum extent that could be expected from a good director in a similar situation under similar circumstances;
- Not cause the company to act unlawfully;
- Regularly attend and actively participate in Supervisory Board meetings;
- Place matters on the agenda of Supervisory Board meetings, and demand such meetings when necessary;
- Ensure that an efficient and effective system of internal control is in place;
- Demand that the General Director and Executive Board members provide adequate information to the Supervisory Board so that its members are properly informed on corporate matters;[180] and
- Exercise a reasonable amount of supervision over management.

2. The Duty of Loyalty

The duty of loyalty is of central importance to the governance framework, underpinning the effective implementation of key corporate governance issues, for example, monitoring of related party transactions and establishing remuneration policies for managers and non-executive directors.

The duty of loyalty requires directors to exercise their powers in the interests of the company as a whole. Simply put, directors should not allow personal interests to prevail over the company's interests. The duty of loyalty usually prohibits directors from:

- Participating in a competing company;
- Entering into any transaction with the company without first disclosing the transaction and obtaining Supervisory Board or GMS approval;

[179] FCSM Code, Chapter 3, Section 3.1.1.

[180] FCSM Code, Chapter 3, Section 3.1.2.

- Using corporate property and facilities for personal needs;
- Disclosing non-public, confidential information; and
- Using company information or business opportunities for private advantage, i.e. personal profit or gain.

It is also a key principle for directors who are working within the structure of a group of companies: even though a company might be controlled by another enterprise, the duty of loyalty for a director relates to the company and all its shareholders, and not to the controlling company of the group.[181]

Best Practices: The duty of loyalty requires the director to act in the best interest of the company regardless of:[182]

- Who nominated and elected such member; and
- Pressures from other directors, shareholders, or other individuals to take actions or make decisions that are not in the best interest of the company.

It is of fundamental importance that, in carrying out its duties, the Supervisory Board should not be viewed, or act, as an assembly of individual representatives for various constituencies.[183] While specific directors may indeed be nominated or elected by certain shareholders (and sometimes contested by others), it is an important feature of the Supervisory Board's work that directors when they assume their responsibilities carry out their duties in an even-handed manner with respect to all shareholders. This principle is particularly important to establish in the presence of controlling shareholders that are able to select all directors.

Further, directors and affiliated persons (for example, family, friends, and business partners) should not accept gifts from persons interested in Supervisory Board decisions, or accept any other direct or indirect benefits. An exception can be made for symbolic gifts that are given as a common courtesy or souvenirs that are given during official events. These exceptions should be described in by-laws or other internal documents of the company.

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[181] OECD Principles of Corporate Governance, Annotations to Principle V.A. on the Responsibility of the Board. See also: www.oecd.org.

[182] FCSM Code, Chapter 3, Section 3.1.3.

[183] OECD Principles of Corporate Governance, Annotations to Principle V.B. on the Responsibility of the Board. See also: www.oecd.org.

a) Conflicts of Interest

A director should not discharge his duties if there is a conflict of interest between him and the company and its shareholders.

Best Practices: A conflict of interest may arise when:[184]

- The company enters into a transaction in which a director is interested;
- A director, directly or indirectly, acquires shares of the company;
- A director accepts an official position on the Supervisory Board of a competing company; and/or
- When a director enters into contractual relations with a competing company.

The Company Law addresses the issue of conflicts of interest within the context of related party transactions.[185]

➜ *For more information on related party transactions and the role of directors in such transactions, see Part III, Chapter 12, Section C.3.*

Directors should refrain from actions that may potentially result in a conflict between their own interests and the interests of the company. They are also advised to refrain from voting in situations where they have a personal interest in the matter in question. Directors should immediately inform the Supervisory Board through the Corporate Secretary about any potential conflicts of interest.

A director must disclose to the Supervisory Board, the Revision Commission and the External Auditor information about:[186]

- Legal entities in which he, either individually or together with affiliated parties, possesses at least 20% of the equity;[187]

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[184] FCSM Code, Chapter 3, Section 3.1.4.

[185] LJSC, Article 83, Clauses 2 and 3.

[186] LJSC, Article 82.

[187] However, holdings of less than 20% of the equity in other legal entities should not be necessarily construed as an absence of a potential conflict of interest.

- Legal entities in which he holds a position in the Supervisory Board and/or executive bodies; and
- Any pending or planned transactions of the company in which he can be considered an interested party.

b) Confidentiality of Information

Best Practices: Directors should not disclose confidential information or use their access to company information for their personal interests or the interests of third parties. The personal use of confidential information ultimately damages shareholders.[188] It is recommended that:[189]

- Directors take steps to protect confidential information;
- Directors not disclose information or use it in their own interests;
- Standards for the use of confidential information be specified in the internal documents of the company; and
- Contracts between the company and directors stipulate the obligation of directors to not disclose confidential information for a period of ten years after they leave the company.

To create an effective mechanism to prevent the unauthorized use of confidential information, the company should require directors to:[190]

- Notify the Supervisory Board in writing of their intention to enter into transactions that involve securities of the company or its subsidiaries; and
- Disclose information about previous transactions with securities of the company in accordance with the procedures for disclosing material facts as specified by securities legislation.

c) Formalization of the Duties of Directors

Best Practices: The company should develop and incorporate into its internal documents a list of clearly defined duties of Supervisory Board members.[191]

➜ *For a list of duties of directors, see the model by-law for the Supervisory Board in Part VI, Annex 6.*

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[188] FCSM Code, Chapter 3, Section 3.3.

[189] FCSM Code, Chapter 3, Section 3.3.

[190] FCSM Code, Chapter 3, Section 3.3.

[191] FCSM Code, Chapter 3, Section 3.4.

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3. Director Access to Information

Best Practices: It is essential for directors to have access to the information they need to properly discharge their duties, including full and accurate responses to their inquiries from members of the executive bodies, and other company officers.[192]

The company should create a mechanism to ensure that directors are provided with information about the most important financial and business developments of the company, as well as other developments that may have an impact on shareholder interests. The by-laws or other internal documents should provide that the General Director, Executive Board members, and heads of major divisions have the duty to promptly submit full and reliable information to the Supervisory Board.[193]

The company's internal documents should include the right of directors to demand information from the executive bodies.[194]

➜ *See Part VI, Annex 6 for a model by-law for the Supervisory Board and a list of materials to be made available to directors prior to Supervisory Board meetings.*

4. Liabilities of Directors

Directors can be held liable for losses caused to the company resulting from their wrongful behavior.[195] The preconditions for establishing liability are:

- Specific conduct or a failure to act;
- Fault, including both negligent and intentional conduct;
- Losses to the company; and
- Causality between the director's behavior and losses.

If there are several directors that caused losses to the company, they are jointly and severally liable.[196] The representatives of state or municipal entities on

[192] FCSM Code, Chapter 3, Section 4.6.

[193] FCSM Code, Chapter 3, Section 4.6.

[194] FCSM Code, Chapter 3, Section 3.4.

[195] LJSC, Article 71, Clause 2; CC, Article 401, Clause 1.

[196] LJSC, Article 71, Clause 4.

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the Supervisory Board are liable to the same extent as other directors.[197] It is important that customary business practices and other relevant circumstances be taken into consideration to determine the grounds and the amount of liability of directors.[198]

Best Practices: The company should:[199]
- Encourage directors to perform their duties in a proper way;
- Take measures to terminate the authority of directors who are responsible for inflicting losses; and
- Hold directors responsible when they do not fulfill their obligations towards the company.

5. When Directors Are Relieved from Liability

Managing the affairs of a company is a complex process with the risk that decisions made by the Supervisory Board, acting reasonably and in good faith, will ultimately prove wrong and entail adverse consequences for the company. Directors cannot generally be held liable for decisions made in good faith.

Moreover, directors cannot be held liable for losses if they:[200]

- Voted against the decision taken by the Supervisory Board that resulted in adverse circumstances; or
- If they did not participate in the Supervisory Board meeting when such a decision was made. (This means that the presence of the directors was not counted for the quorum of the Supervisory Board meeting.)

Directors are not relieved from liability after they have resigned from the Supervisory Board or when they are dismissed from the Supervisory Board for actions and decisions made during their tenure as a director.

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[197] LJSC, Article 71, Clause 6.

[198] LJSC, Article 71, Clause 3.

[199] FCSM Code, Chapter 3, Sections 6.1.1 and 6.1.2.

[200] LJSC, Article 71, Clause 2.

6. Who Can File a Claim Against Directors

The company or a shareholder (or a group of shareholders) holding at least 1% of common shares have the right to file a claim in court against directors to cover the losses of the company that resulted from decisions taken by the Supervisory Board.[201]

7. The Minutes of Supervisory Board Meetings and Director Liability

Best Practices: To effectively enforce provisions that regulate the liability of directors, it is recommended that the company keep detailed minutes (and possibly verbatim reports) of meetings.[202] As stated above, if a decision passed by the Supervisory Board results in the company incurring losses, only those directors who voted for such a decision are liable. Therefore, it is important for the Supervisory Board to keep detailed minutes of Supervisory Board meetings to determine who voted for a certain decision and who can be held liable.[203]

8. Protection from Liability for Directors

Best Practices: Most companies should allow their directors to protect themselves from, or at least limit the liability for, losses incurred while they fulfilled their duties. Such mechanisms are:[204]

- Officer and director liability insurance; and
- Provisions in the charter and by-laws that indemnify directors against claims, litigation expenses, and liabilities in certain circumstances.

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[201] LJSC, Article 71, Clause 5.

[202] FCSM Code, Chapter 3, Section 4.16.1.

[203] FCSM Code, Chapter 3, Section 4.16.1.

[204] In Western companies, directors are often protected by the presumption that if they acted in good faith and in a manner they considered to be in the best interests of the company, they should not be held liable for losses caused to the company by their decisions. This is called the “business judgment rule” and it can be used to protect directors from liability.

Companies may reimburse a director for expenses incurred in defending a claim related to his role as a Supervisory Board member, if he acted:

- Honestly;
- In good faith;
- In the best interests of the company; and
- In compliance with law, the charter, and by-laws.

A company may wish to obtain liability insurance for directors to cover the risk that their actions might result in losses to the company or third parties. Liability insurance for directors should allow the company to use civil law remedies more productively. It is also often needed to attract competent directors.[205]

G. Evaluation and Education of the Supervisory Board and Directors

To be effective, Supervisory Boards should have the necessary resources to develop and maintain the knowledge and skills of its directors. Training programs, based on periodic evaluations of the Supervisory Board and its members, are fundamental to this end.

Best Practices: The importance of Supervisory Board evaluations is widely recognized in the international business community. The FCSM Code also recommends that:[206]

- The Supervisory Board evaluate its performance annually; and
- The annual report reflect the results of the performance evaluation.

The performance evaluation of the Supervisory Board and its members may be carried out by:

- Directors through self-evaluation; and/or
- Consultants, professional associations, and corporate governance rating organizations.

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[205] FCSM Code, Chapter 3, Section 6.1.2.

[206] FCSM Code, Chapter 3, Section 5.1.3.

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An alternative approach calls for confidential Supervisory Board peer evaluations coordinated by an external party, such as legal counsel or specialized consultants.

1. Self-Evaluation by the Supervisory Board

A self-evaluation is a useful tool for the Supervisory Board to privately assess the quality of its work. Through critical reflection and self-evaluation, directors can be more responsive to shareholders, investors, and other stakeholders. Self-evaluation methods include:

- Organizing a retreat and inviting an outside facilitator;
- Organizing a special Supervisory Board meeting to evaluate the work of the Supervisory Board or, alternatively, setting aside time during a regular meeting to address performance issues;
- Designing checklists that Supervisory Board members can use to assess their work; and
- Participating in specialized training programs, thereby providing directors the opportunity to critically reflect on their performance, and develop and share new ideas.

➜ *See the model checklist for the Supervisory Board's self-evaluation in Part VI, Annex 17.*

Best Practices: Another useful way to evaluate the Supervisory Board is to invite a consultant, advisor, institute of directors, or rating agency to independently assess the Supervisory Board. Rating agencies for example, not only evaluate the Supervisory Board, but also evaluate other aspects of the company's corporate governance system.

2. Education and Training

The evaluation of the Supervisory Board and its members can reveal important insights into the Board's strengths and weaknesses. This information can also be used by the Supervisory Board to identify training needs, both collectively and individually. Corporate training events take on added importance in the context of transition economies, as directors need to be kept abreast of changes to the legal and regulatory framework, as well as best practices. All this makes a company

education policy for the Supervisory Board and its directors a key success factor in developing and supporting a competent, knowledgeable, and vigilant Board.[207]

Company Practices in Russia: Only 5.6% of companies organized paid training events for directors during 2002.[208] On average, such companies spent U.S. $ 9,671 per year. Larger companies tend to pay more attention to the organization of trainings for directors. 14% of companies with over U.S. $ 3.3 million in turnover organized trainings on corporate governance for their directors during the last year, compared to 6.1% of companies with turnover of U.S. $ 1.6 to 3.3 million.

Even fewer companies (3.9%) used the services of consulting firms to assist them on corporate governance issues. Overall, fees spent on consulting services were U.S. $ 15,333 on average per company per year.

H. The Remuneration of Directors

Directors may be remunerated for their work. The amount of such remuneration is determined by the GMS.[209]

The issue of director remuneration is one of the more contentious in the field of corporate governance, and companies are advised to choose a cautious and circumspect approach to the question of Supervisory Board remuneration. Excessive compensation plans are often perceived as an unjustified privilege of power. As a consequence, it is of the utmost importance that director compensation be competitive, yet stay within reasonable limits.

An important distinction in this respect must however be made between executive and non-executive directors. As a rule, executive directors do not receive additional fees for their participation on the Supervisory Board. Their executive compensation packages are generally thought to include Supervisory Board duties. Non-executive directors, on the other hand, should be remunerated. The most

[207] At present, there are several organizations that offer director education programs in Russia, including the Independent Director Association (www.independentdirector.ru) and the Russian Institute of Directors (www.rid.ru). The IFC and its Russia Corporate Governance Program also offer corporate training events on corporate governance (www.ifc.org/rcgp).

[208] IFC Survey on Corporate Governance Practices in Russia's regions, Section 2.2.1, pages 26–27, August 2003 (see www.ifc.org/rcgp).

[209] LJSC, Article 64, Clause 2.

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common form of remuneration for non-executive directors is a monetary fee. For example, directors can receive:

- An annual fee (which may be paid in the form of shares in lieu of cash);
- A fee, based upon meeting attendance;
- Fees for additional work, such as for work on Supervisory Board committees; and
- Fees for additional responsibilities, such as for serving as the Chairman of the Supervisory Board or one of its committees.

Directors can also be reimbursed for travel costs and other business expenses.

Best Practices: The remuneration payable to directors should be equal for all non-executive directors.[210] Moreover, the fees that a company pays should be competitive, i.e. sufficient to attract competent individuals. They should be set so that they are neither very much below nor above director fees paid at a peer group of companies. Setting a reasonable level of director remuneration is particularly important in order not to jeopardize the special status of independent directors. Independent or not, a director's judgment may be clouded if he receives a significant percentage of his total income in the form of a director fee. A director who relies on Board compensation for his livelihood will soon become beholden to the company, and may not be relied upon to fill his responsibilities in an unbiased manner.

The Supervisory Board should regularly review the remuneration of directors.

Best Practices: Ideally, this should be done either by a remuneration committee, composed entirely of independent directors, or by the independent directors. The company should disclose its remuneration plan and the remuneration of each director, either on an individual basis or in the aggregate, in its annual report. The former is easiest to implement when all Board members receive the same fees with a simple statement in the annual report: "All non-executive directors receive fees of RUR _____ per year."

Great care needs to be exercised in establishing performance-based remuneration, in particular, stock-based remuneration. Performance-based remuneration is generally considered a factor that impinges director independence.

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[210] FCSM Code, Chapter 3, Section 5.1.

Best Practices: While stock-based remuneration is common in the U.S., it is a good deal less common elsewhere and considerable controversy still surrounds it. Stock-based remuneration plans and, in particular, stock option plans are complex arrangements. While they are generally thought to provide incentives for managers and directors, they can also have a significant impact upon the company and shareholders.

- Stock options, it is argued, cause directors to focus on short-term performance and stock price movements.
- If stock option grants are large, they may also create complicity between directors and executives who stand to make enormous sums from short-term price movements.
- Shareholders risk share dilution when large option plans are granted.
- Finally, large option grants have not prevented managers from manipulating companies and financial information to their benefit.

Consequently, option plans are coming under increasing scrutiny. Such plans require careful consideration, good planning, and special disclosure. Companies may be best served by avoiding stock options for directors.

If a company chooses to implement stock option plans, it should be transparent about the costs in terms of share dilution. The company should also be transparent about the accounting methods used to measure the costs of stock and option grants. Best practices would call for shareholder approval of stock- or option-based compensation plans that could dilute shareholder value or affect profits.

Personal loans or credits to the company's directors are also a minefield and a potential source of controversy that companies would be well advised to avoid.

Company Practices in Russia: Some 70% of companies do not have a remuneration policy for Supervisory Board members.[211] The average annual compensation of Supervisory Board members in companies with less than 1,000 shareholders is U.S. $ 475. Larger companies tend to pay higher fees. Companies with over 1,000 shareholders pay fees of U.S. $ 1,200 per annum.

The low level of remuneration compared to the importance of the Supervisory Board is striking. Whatever the explanation, it seems clear that director remuneration needs to receive greater attention. Transparent systems of remuneration, capable of attracting qualified directors, need to be put in place.

[211] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.2.1, page 21, August 2003 (see www.ifc.org/rcgp).

Finally, as a matter of good practice, directors that are remunerated for their services should sign a contract with the company.

I. Summary Checklist to Determine the Supervisory Board's Effectiveness[212]

Questions	Yes	No
1. Has the Supervisory Board recently devoted a significant amount of time and serious thought to the company's longer-term objectives, and to the strategic options open to it for achieving them? If so, have these deliberations resulted in a Board consensus or decision on its future objectives and strategies, and have these been put in writing?	☐	☐
2. Has the Supervisory Board consciously thought about and reached formal conclusions on what is sometimes referred to as its basic corporate philosophy that is, its value system, its ethical and social responsibilities, its desired 'image' and so forth? If so, have these conclusions been set forth in explicit statements of policy, for example, in respect of terms of employment? Does the company have formal procedures for recording and promulgating major Supervisory Board decisions as policy guidelines for line managers?	☐	☐
3. Does the Supervisory Board periodically review the organizational structure of the company, and consider how this may have to change in future? Does it review and approve all senior appointments as a matter of course? Are adequate human resource development programs in place?	☐	☐
4. Does the Supervisory Board routinely receive all the information it needs to ensure that it is in effective control of the company and its management? Have there been any unpleasant surprises, for example, unfavorable results or unforeseen crises that could be attributed to a lack of timely or accurate information?	☐	☐
5. Does the Supervisory Board routinely require the General Director to present his annual plans and budgets for their review and approval? Does the Board regularly monitor the performance of the General Director and his immediate subordinate managers in terms of actual results achieved against agreed plans and budgets?	☐	☐

[212] Source: Parker, Hugh, Letters to a New Chairman, (1990) London: Director Publications, pp. 12–14. (As cited in Cadbury, Adrian, Corporate Governance and Chairmanship, (2002) Oxford University Press, pp. 47–48.)

6. When the Supervisory Board is required to take major decisions on questions of future objectives, strategies, policies, major investments, senior appointments, etc., does it have adequate time and knowledge to make these decisions soundly — rather than finding itself overtaken by events and, in effect, obliged to rubber-stamp decisions already taken or commitments already made?	☐	☐

If the answers to all of these questions are yes, it is safe to say that the company's Supervisory Board can be considered effective. If the answers are negative, or perhaps not clear, then the company needs to re-evaluate the composition and role of its Supervisory Board.

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