



# Chapter 5

## The **Executive Bodies**



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## **The Chairman's Checklist**

- ✓ Does the company have a clear delineation and separation of authorities between shareholders, directors, and managers? Has the company properly established an Executive Board? Does the charter clearly distinguish the powers of the General Director from those of the Executive Board?
- ✓ Do the General Director and all Executive Board members possess the knowledge and skills necessary to manage the company? Do they perform their functions on a full-time basis? Is there a transparent division of tasks among the Executive Board members, such as operations, marketing, finance, and legal?
- ✓ Who elects members of the executive bodies? Is the General Director sufficiently involved in the nomination process or other executives?
- ✓ Do the executive bodies meet regularly to discuss the affairs of the company? Are these meetings well prepared with an agenda and reference materials distributed in advance (in writing and/or electronically)?
- ✓ Do the General Director and the Executive Board regularly and adequately inform the Supervisory Board about all operations of the company? Do the executive bodies provide all relevant information to the Supervisory Board, the Revision Commission, and the External Auditor in a timely manner?
- ✓ Do all members of the executive bodies clearly understand their duties to act reasonably and in good faith in the best interests of the company? Does the Supervisory Board take measures to ensure that managers who fail to act in accordance with these duties are held liable under civil, administrative, and/or criminal law?
- ✓ Are thorough performance reviews of the executive bodies based on key performance indicators periodically conducted? Does the Supervisory Board rigorously evaluate executives at least annually, if not more frequently? Does the Supervisory Board clearly link performance and remuneration when deciding on executive remuneration?
- ✓ Do all directors fully understand how stock options function? Are all directors and shareholders aware of the different methods of recording and reporting the cost of stock options? Has the Supervisory Board critically examined the use of options as an incentive tool, ensured that option grants are not merely a management giveaway, and communicated this fully and effectively to shareholders?

The executive bodies manage the company's day-to-day activities. They implement the strategic direction set out by the Supervisory Board and/or the General Meeting of Shareholders (GMS), and are an essential part of the company's governance structure.<sup>213</sup> This chapter describes the authorities, composition, formation, and working procedures of executive bodies, as well as their interaction with the Supervisory Board, their duties and liabilities, evaluation, and remuneration.

### A. The Executive Bodies and Their Authorities

According to the Company Law, executive bodies can be either:<sup>214</sup>

- A single-person executive body, i.e. General Director; or
- A collective executive body, i.e. the Executive Board, consisting of the General Director and one or more managers.

A company must always have a General Director. The formation of the Executive Board and the employment of an External Manager are, on the other hand, optional.

**Best Practices:** The Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code) recommends that the company establish an Executive Board.<sup>215</sup> It argues that the management of the company's day-to-day activities is complex, requiring a collective rather than individual approach. An Executive Board also facilitates discussion and coordination among key managers on important issues. The Executive Board assembles the key resources at the General Director's disposal to help achieve the company's goals.

As a rule, the executive bodies have the authority to decide all issues that do not fall under the authority of the GMS and/or the Supervisory Board.<sup>216</sup> Matters

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<sup>213</sup> Law on Joint Stock Companies (LJSC), Article 69, Clauses 1 and 2; FCSM Code, Chapter 4, Introduction.

<sup>214</sup> LJSC, Article 69, Clause 1.

<sup>215</sup> FCSM Code, Chapter 4, Section 1.1.

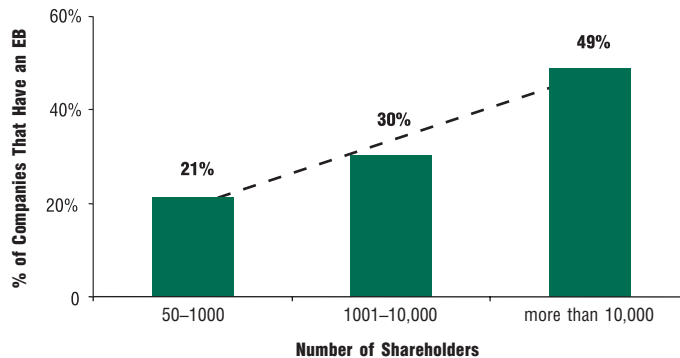
<sup>216</sup> LJSC, Article 69, Clause 2, Paragraph 1.

that do fall within the authority of the GMS and/or the Supervisory Board cannot be delegated to the executive bodies.<sup>217</sup> Furthermore, the charter must specify the authority of the executive bodies.<sup>218</sup>

Company Law allows the company to employ an External Manager, which is typically either a commercial organization (management organization) or an individual entrepreneur (manager), to fulfill the role of an executive body.

**Company Practices in Russia:** An ever increasing number of Russian companies have Executive Boards. A survey of governance practices in Russia's regions shows that the larger the company, the more likely it is to have an Executive Board.<sup>219</sup> Larger companies may need an Executive Board to deal with more complex business models and organizational structures. Smaller companies typically have simpler business models and fewer resources to establish formal structures. (See Figure 1.)

Figure 1: Existence of an Executive Board (EB)



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

<sup>217</sup> LJC, Article 48, Clause 2; Article 65, Clause 2.

<sup>218</sup> LJC, Article 11, Clause 3, Paragraph 1.

<sup>219</sup> IFC Survey on Corporate Governance Practices in Russia's regions, Section 2.2.2, page 29, August 2003 (see [www.ifc.org/rcgp](http://www.ifc.org/rcgp)).

**Best Practices:** The work of the executive bodies should be guided by a financial and business plan that is approved annually by the Supervisory Board.<sup>220</sup> The financial and business plan should contain basic guidelines for the daily operations of the company. Good corporate governance principles further recommend that:<sup>221</sup>

- The General Director and 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);<sup>222</sup>
- The company develop by-laws or other internal documents detailing procedures for the General Director and Executive Board to obtain such approval from the Supervisory Board; and
- The Supervisory Board have the right to veto decisions made by the General Director and Executive Board to implement non-standard operations.

### 1. The Authority of the General Director

The authority of the General Director is defined by the Company Law and summarized in Figure 2.<sup>223</sup>

### 2. The Authority of the Executive Board

If the company establishes an Executive Board, the charter must define the authority of the General Director and the Executive Board,<sup>224</sup> in particular since the Company Law does not do so. Such division of authority is at the discretion of the company.

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<sup>220</sup> FCSM Code, Chapter 1, Section 7.1.

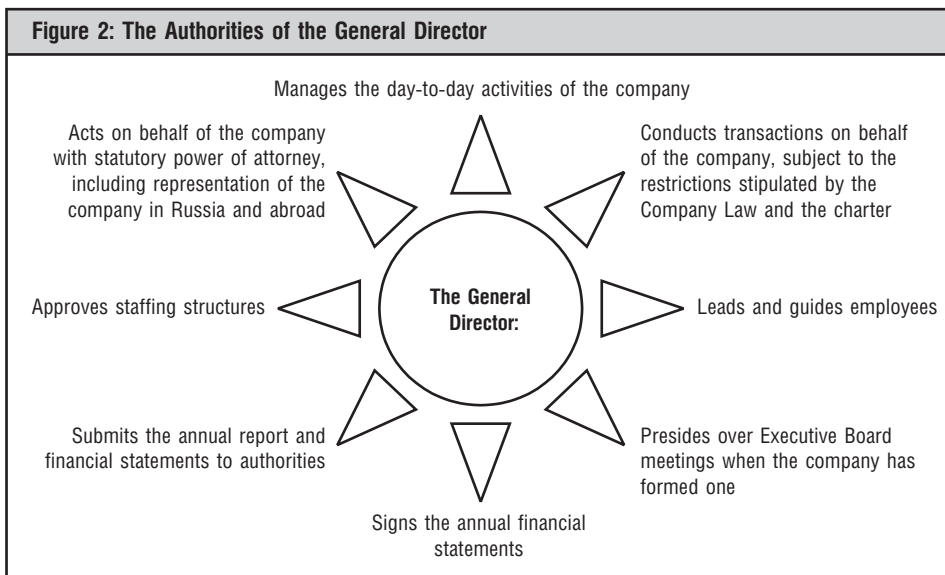
<sup>221</sup> FCSM Code, Chapter 4, Section 1.2.

<sup>222</sup> FCSM Code, Chapter 8, Section 2.2.3.

<sup>223</sup> LJSC, Article 69, Clause 2, Paragraphs 1–3; Article 88, Clause 2. 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 3.7.

<sup>224</sup> LJSC, Article 69, Clause 1, Paragraph 2.

**Figure 2: The Authorities of the General Director**



Source: IFC, March 2004

**Best Practices:** The company charter should define the Executive Board's authority to:<sup>225</sup>

- Develop documents on the priority area(s) of the company's operations;
- Develop the business plan(s) of the company;
- Approve by-laws or other internal documents;
- Approve transactions with a value of 5% and more of the company's assets with the requirement that the Supervisory Board be immediately notified;
- Approve real estate transactions and loans that are not part of the ordinary course of business;
- Appoint the heads of the company's branches and representative offices;
- Approve issues on the agenda of the GMS of wholly-owned subsidiaries unless these issues must be approved by the Supervisory Board of the parent company;
- Appoint individuals who represent the company during the GMS of wholly-owned subsidiaries and instruct them on how to vote during the GMS;
- Nominate candidates for the General Director, the Executive Board, the External Manager, the Supervisory Board, and other governing bodies of wholly-owned subsidiaries;

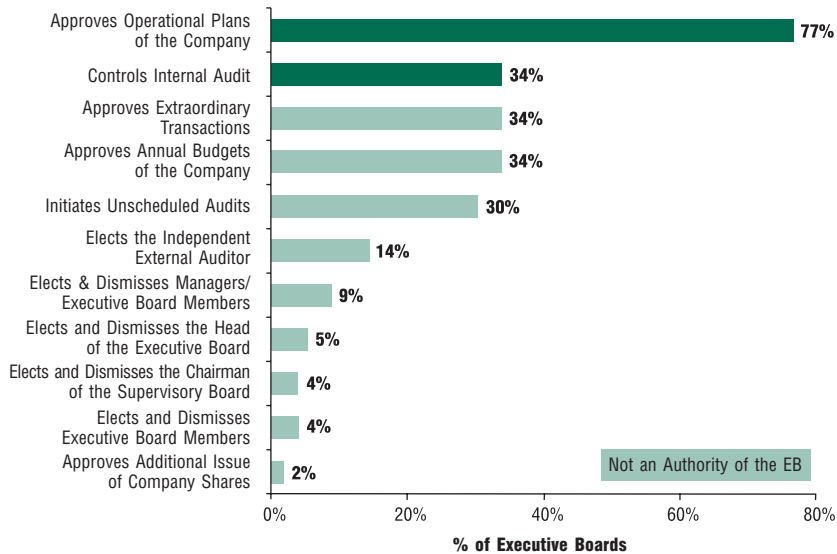
<sup>225</sup> FCSM Code, Chapter 4, Sections 1.1.2 — 1.1.5.

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- Approve internal work schedules;
- Approve job descriptions for all management-level employees of the company;
- Approve employment contracts for mid-level managers; and
- Approve collective labor contracts.

**Company Practices in Russia:** Both the Company Law and the FCSM Code define the authorities of the governing bodies. However, these bodies often confuse their authorities in practice. This holds particularly true for executive bodies. While misunderstandings may go unnoticed, they are technically illegal and may result in the reversal of decisions and, in some cases, even litigation. Figure 3 illustrates how executive boards in a sample of Russian companies have assumed some powers of the Supervisory Board and the GMS.<sup>226</sup>

**Figure 3: Functions Performed by Executive Boards (EB)**



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

<sup>226</sup> IFC Survey on Corporate Governance Practices in Russia's regions, Section 2.2.2, page 30, August 2003 (see [www.ifc.org/rcgp](http://www.ifc.org/rcgp)).



### 3. The Authority and Qualifications of the External Manager

The GMS can delegate the authority of the General Director to an External Manager by written agreement.<sup>227</sup>

**Best Practices:** The GMS can only delegate the authority of the single-person executive body. Thus, in cases when the General Director is the Chairman of the Executive Board, the GMS must first dissolve the Executive Board and then delegate the General Director's authority.

The GMS can only decide on the delegation of the authority of the General Director to an External Manager upon the recommendation of the Supervisory Board.

**Best Practices:** The Supervisory Board should provide the GMS with a clear justification for the use of an External Manager and explain the:<sup>228</sup>

- Reasons;
- Risks;
- Costs;
- Individuals who are accountable to the Supervisory Board on behalf of the External Manager;
- Other companies that are managed by the External Manager; and
- Identity of the Supervisory Board members, executive bodies and major shareholders of the External Manager, as well as any and all information that may be required to identify potential conflicts of interests.

The External Manager fulfills the functions of the General Director and is accountable to the Supervisory Board and the GMS. The Company Law does not specify the requirements of the agreement with the External Manager other than that the Chairman, or another individual who is duly authorized, sign the contract on behalf of the company.<sup>229</sup>

<sup>227</sup> LJSC, Article 69, Clause 1, Paragraph 3.

<sup>228</sup> FCSM Code, Chapter 1, Section 4.2; Chapter 4, Sections 2.1.7 – 2.1.9.

<sup>229</sup> LJSC, Article 69, Clause 3, Paragraph 2.

**Best Practices:** The Supervisory Board and the GMS should have access to:<sup>230</sup>

- Documents that prove that the External Manager has sufficient financial resources or adequate liability insurance in the event of failure to perform obligations in accordance with the contractual agreement with the company, as well as the External Manager's financial statements;
- The charter of the External Manager (if it is a legal entity); and
- The contract with the External Manager including the:<sup>231</sup>
  - Goals that the External Manager is asked to achieve;
  - Remuneration of the External Manager;
  - Standards of liability applicable to the External Manager;
  - Procedures for the removal of the External Manager (contract termination clause);
  - List of reports, which the External Manager must submit to the Supervisory Board and the GMS, including the periodicity of these reports.

Further, the External Manager should not work for a competing company in any capacity or have any significant connections with such company.

The GMS may terminate the authority of the External Manager at any time.<sup>232</sup> Note that the contractual agreement between the company and External Manager will also need to be terminated and that (additional) compensation may be payable to the External Manager for premature termination of his employment agreement.

## B. The Composition of the Executive Bodies

### 1. Who Can Be a General Director or an Executive Board Member

Any individual can be the General Director or an Executive Board member. Restrictions do, however, exist:

- Only individuals with “full dispositive capacity” can be members of the executive bodies. This means that a person must have the capacity to acquire

<sup>230</sup> FCSM Code, Chapter 4, Section 2.1.9.

<sup>231</sup> FCSM Code, Chapter 4, Section 2.1.10.

<sup>232</sup> LJSC, Article 69, Clause 4, Paragraph 1.

- and exercise civil law rights by his actions, be able to create for himself civil law obligations, and be able to fulfill these rights and obligations;<sup>233</sup>
- A legal entity cannot be an Executive Board member;
  - The Chairman of the Supervisory Board cannot be the General Director;<sup>234</sup>
  - Revision Commission members cannot be a member of the executive bodies;<sup>235</sup>
  - Counting Commission members cannot be a member of the executive bodies;<sup>236</sup> and
  - A member of the company's executive bodies can only be a member of the executive bodies or Supervisory Board of another company after the Supervisory Board has given its consent.<sup>237</sup>

**Best Practices:** Best practices dictate that individuals should not be appointed to executive bodies when they are:<sup>238</sup>

- Directors of a competing company;
- Managers of a competing company; or
- Employees of a competing company.

The General Director should not be engaged in any business activities other than those related to the management of the company and the governance of its subsidiaries.<sup>239</sup>

## 2. Qualifications of the General Director and Executive Board Members

Members of the executive bodies can only be effective when they have adequate financial and human resources, as well as the necessary knowledge, skills, time, and experience to exercise their duties.<sup>240</sup>

<sup>233</sup> Civil Code (CC), Article 21.

<sup>234</sup> The General Director can, however, hold any other position on the Supervisory Board, including the position of Deputy Chairman.

<sup>235</sup> LJSC, Article 85, Clause 6.

<sup>236</sup> LJSC, Article 56, Clause 2.

<sup>237</sup> LJSC, Article 69, Clause 3, Paragraph 4.

<sup>238</sup> FCSM Code, Chapter 4, Section 2.1.3.

<sup>239</sup> FCSM Code, Chapter 4, Section 2.1.4.

<sup>240</sup> FCSM Code, Chapter 1, Section 4.2; Chapter 4, Section 2.1.4.

**Best Practices:** The charter or by-laws should specify the qualifications of members of the executive bodies as well as heads of major divisions.<sup>241</sup> Members of the executive bodies, including the External Manager, should generally satisfy the following requirements:<sup>242</sup>

- To enjoy the trust of shareholders, directors, other managers, and employees of the company;
- To own the ability to relate to the interests of all stakeholders and to make well-reasoned decisions;
- To possess the professional expertise and education to be an effective General Director and manager;
- To possess (international) business experience, knowledge of national economic, political, legal, and social issues, as well as trends and knowledge of the market, products, and competitors (national as well as international); and
- To have the ability to translate knowledge and experience into practical solutions that can be applied to the company.

Moreover, a background check on candidates should be conducted for a possible record of criminal or administrative offenses. Evidence of such offenses would likely result in the rejection of a candidate.

### 3. The Composition of the Executive Board

The number of Executive Board members, together with their duties and responsibilities, is set forth in the company's charter.<sup>243</sup>

**Company Practices in Russia:** A Russian company's Executive Board will typically consist of the General Director and between five and seven other members. Figure 4 illustrates the number of Executive Board members in Russian companies of different sizes.<sup>244</sup>

The size of the Executive Board will need to be adapted to the specific circumstances of the company and, consequently, will vary in composition. The Executive Board might include the following persons:

<sup>241</sup> FCSM Code, Chapter 4, Sections 2.1.1 and 2.1.8.

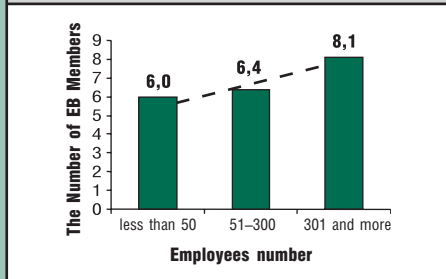
<sup>242</sup> FCSM Code, Chapter 4, Section 2.1.4.

<sup>243</sup> LJSC, Article 11, Clause 3.

<sup>244</sup> IFC Survey on Corporate Governance Practices in Russia's regions, Section 2.2.2, page 29, August 2003 (see [www.ifc.org/rcgp](http://www.ifc.org/rcgp)).

- The General Director;
- The Chief Operating Officer;
- The Chief Financial Officer;
- Chief Legal Counsel;
- Marketing and Sales Director;
- Head of Purchasing;
- Head of Research and Development;
- Head of Information Technology;
- Head of Public/Investor Relations;
- Heads of Business/Product Lines;
- The General Director of a dependent company or subsidiary; and/or
- The Human Resources Director.

Figure 4: The Number of Executive Board (EB) Members



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

### C. The Formation and Termination of the Executive Bodies

The Company Law is flexible on who elects the executive bodies. It allows for the following options:<sup>245</sup>

- The election of the General Director and Executive Board members by the GMS; or
- The election of the General Director and Executive Board members by the Supervisory Board if the charter provides so; or
- The election of the General Director by the GMS and of Executive Board members by the Supervisory Board if the charter provides so.

**Best Practices:** High-level personnel decisions, in general, and the selection of Executive Board members, more specifically, are best accomplished by the General Director, in tandem with the Supervisory Board. Personnel decisions

<sup>245</sup> LJSC, Article 48, Clause 1, Section 8; Article 65, Clause 1, Section 9; Article 69, Clause 3, Paragraph 1.

should not be political decisions. The assessment of the skills and qualifications of potential Executive Board members is best done by someone who works day in and day out with potential candidates. Shareholders or Supervisory Boards that insist on close control over this process may be better served by developing policies that specify outcomes rather than getting involved in the details of selection. Drafting precise and effective terms of reference for key executive positions is but one example. At the very least, proposals for membership on the Executive Board should be closely coordinated with the General Director, by having him nominate and the Supervisory Board approve candidates.

### 1. The Election of the Executive Bodies by the General Meeting of Shareholders

**Best Practices:** The involvement of the GMS in the election of executive bodies can empower shareholders to decide on who should run the company. It is also better suited to protect the rights of shareholders since they not only vote on managers but also have the right to propose candidates. The FCSM Code recommends that the GMS elect the executive bodies.<sup>246</sup>

On the other hand, almost every other corporate governance system has the Supervisory Board elect the General Director. The Supervisory Board is in a better position compared to shareholders to set the key criteria for what kind of General Director the company needs, organize proper succession planning, and search for such a person. For this purpose, the Supervisory Board may even establish an independent Nominations Committee, which will be in charge of making a recommendation as to potential candidates for the position of General Director. Shareholder interests are not adversely affected, as the Supervisory Board members are bound by their duties of loyalty and care to act in the best interests of the company and its shareholders. It is especially advisable to delegate this power to the Supervisory Board in countries in transition such as Russia, where Supervisory Boards are nascent in their development *vis-à-vis* controlling shareholders, and need to be strengthened. Finally, because management oversight is one of the Supervisory Board's main authorities, the Board's authority to dismiss the General Director should coincide with the authority to elect this important individual.

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<sup>246</sup> FCSM Code, Chapter 1, Section 4.2.

Legislation does not specify the minimum and maximum periods for which members of the executive bodies are elected. The charter, by-laws, or the employment agreement can specify the period for which the General Director and Executive Board members are elected. Members of the executive bodies can be re-elected at will.

**Company Practices in Russia:** In practice, the executive bodies are often elected for a period between three and five years. This is considered sufficient time for a manager to become acquainted with the company's business and not to be constrained by short-term goals.

### a) Nomination of Candidates for Executive Bodies

→ *The procedure for nominating candidates for the executive bodies is discussed in Part III, Chapter 8, Section B.1.*

### b) Information About Candidates for the Executive Bodies

Information on candidates for the executive bodies must be submitted to shareholders before the GMS.

**Best Practices:** Shareholders should have the opportunity to receive sufficient information (in writing and/or electronic form) about candidates for the position of General Director and the Executive Board before the GMS. Up-to-date information should also be made available to all shareholders during the GMS.<sup>247</sup> The information about candidates for the executive bodies should include the:<sup>248</sup>

- Identity of the candidate;
- Age and educational background of the candidate;
- Position(s) held by the candidate during the last five years;
- Position(s) held by the candidate at the moment of his nomination;
- Relationship(s) that the candidate has with the company;
- Membership(s) of the candidate in the Supervisory Board of other legal entities, or any other positions held in such entities;
- Information on the nomination(s) of the candidate for a position in the executive bodies and other positions of other legal persons;
- Relationship(s) of the candidate with affiliated persons;

<sup>247</sup> LJSC, Article 52, Clause 3, Paragraph 3.

<sup>248</sup> FCSM Code, Chapter 4, Section 2.2.1. See also: LJSC, Article 53, Clause 4.

- Relationship(s) that the candidate has with major business partners of the company;
- Information related to the financial status of the candidate and other circumstances that may affect the duties of the candidate as a member of the executive bodies; and
- Refusal of the candidate, if any, to provide information to the company.<sup>249</sup>

It is recommended that candidates present a written statement to the GMS that indicates their willingness to accept the position of General Director or Executive Board member, should they be elected.<sup>250</sup> In the absence of such statement, candidates should verbally confirm that they are willing to accept the position during the GMS.

Companies may include provisions in the charter specifying the information that must be provided to shareholders about candidates for the executive bodies.<sup>251</sup>

### **c) The Election of the Executive Bodies by Written Consent**

The Company Law does not prohibit shareholders from electing members of the executive bodies during a GMS that has been conducted without the physical presence of shareholders.<sup>252</sup> It is possible, therefore, to elect members of the executive bodies during a GMS that has been held by written consent.

### **d) The Election of Members of the Executive Bodies When the Executive Board Has an Insufficient Number of Members**

If the number of Executive Board members becomes less than the quorum specified by the charter or by-laws, the Supervisory Board must:<sup>253</sup>

- Appoint an interim Executive Board; and
- Organize an Extraordinary General Meeting of Shareholders (EGM) to elect a new Executive Board.

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<sup>249</sup> FCSM Code, Chapter 4, Section 2.2.1.

<sup>250</sup> FCSM Code, Chapter 2, Section 1.3.6.

<sup>251</sup> LJSC, Article 53, Clause 4; FCSM Code, Chapter 2, Section 2.1.4.

<sup>252</sup> LJSC, Article 50, Clause 2.

<sup>253</sup> LJSC, Article 70, Clause 2.



### e) The Suspension of the General Director's Authorities

In circumstances where the power to form and terminate executive bodies belongs to the GMS, the charter can provide the Supervisory Board with the authority to suspend the powers of the General Director or External Manager.

→ *For more information on the suspension and appointment of interim executive bodies, see Chapter 4, Section A.3.*

### f) The Authority of the Interim General Director

An interim General Director has the same authority as the General Director unless the charter specifies otherwise.<sup>254</sup>

**Best Practices:** An example of a limitation of an interim General Director's authority could be a prohibition to conclude significant transactions without prior Supervisory Board approval, or to conclude transactions in excess of a certain monetary threshold. It is also good practice to limit the power of the interim General Director to make decisions regarding the hiring and firing of personnel.

### g) The Termination of the Authority of the Executive Bodies

The GMS can terminate the authority of executive bodies it has established.<sup>255</sup> Members of the executive bodies are dismissed by a simple majority vote of shareholders participating in the GMS.<sup>256</sup> The GMS cannot terminate the authority of the executive bodies if the charter gives the Supervisory Board the authority to establish the executive bodies.

## 2. The Appointment of the Executive Bodies by the Supervisory Board

The procedures for the appointment and dismissal of members of the executive bodies are less onerous when the Supervisory Board has the authority to establish executive bodies. When the charter allows, the executive bodies are appointed by the Supervisory Board and can be dismissed at any time by this same body. The company will, however, as mentioned above, need to comply with employment

<sup>254</sup> LJSC, Article 69, Clause 4, Paragraph 6.

<sup>255</sup> LJSC, Article 48, Clause 1, Section 8.

<sup>256</sup> LJSC, Article 49, Clause 2.

contracts regarding notice, cause, and possible severance payments. A simple majority of votes of Supervisory Board members is sufficient to appoint members of the executive bodies, unless the charter or by-laws require a higher percentage.<sup>257</sup>

### D. The Working Procedures of the Executive Bodies

#### 1. The Chairman of the Executive Board

The General Director presides over Executive Board meetings.<sup>258</sup> For Executive Board meetings, the General Director (or Chairman of the Executive Board) has the authority to:<sup>259</sup>

- Convene, organize, and preside over Executive Board meetings;
- Sign all documents, decisions, and minutes of the Executive Board; and
- Perform any other duties as specified in the charter and by-laws.

**Best Practices:** In addition, the Chairman of the Executive Board can:

- Facilitate discussions and decision-making, and create a constructive atmosphere; and
- Take steps to ensure that all members are sufficiently prepared to contribute to the work of the Executive Board.

#### 2. Executive Board Meetings

The charter and the by-laws shall establish:<sup>260</sup>

- The frequency of Executive Board meetings;
- The procedures for organizing and conducting Executive Board meetings; and
- The procedures for making decisions during Executive Board meetings.

**Best Practices:** The precise frequency of meetings should, however, ultimately depend on the unique circumstances of each company.

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<sup>257</sup> LJSC, Article 68, Clause 3.

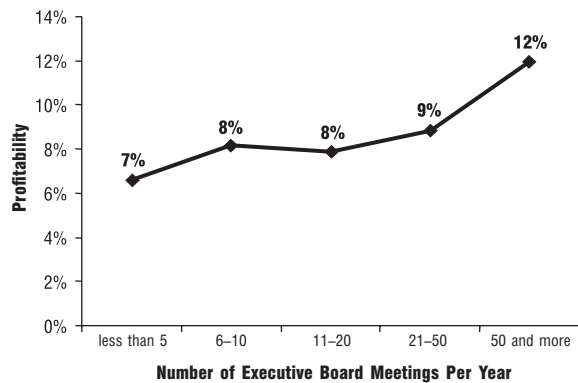
<sup>258</sup> LJSC, Article 69, Clause 1.

<sup>259</sup> LJSC, Article 70, Clause 2.

<sup>260</sup> LJSC, Article 70, Clause 1.

**Company Practices in Russia:** The effectiveness of an Executive Board is likely to be greatly enhanced by frequent meetings. The FCSM Code recommends that the Executive Board meet at least once a week.<sup>261</sup> The IFC survey shows a large gap between this recommended number and actual practice.<sup>262</sup> In fact, only 3% of Executive Boards follow the FCSM Code's recommendation. It is interesting to note that, based on survey results, greater frequency of Executive Board meetings correlates with an increase in profitability (see Figure 5).

**Figure 5: Executive Board Meetings and Profitability**



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

### 3. The Right to Call an Executive Board Meeting

The General Director has the right to convene a meeting of the Executive Board.<sup>263</sup>

**Best Practices:** The Executive Board is a hands-on, problem-solving mechanism. Other Executive Board members should also have a voice in calling Executive Board meetings and setting the meeting agenda.<sup>264</sup>

<sup>261</sup> FCSM Code, Chapter 4, Section 4.1.1.

<sup>262</sup> IFC Survey on Corporate Governance Practices in Russia's regions, Section 2.2.2, page 29, August 2003 (see [www.ifc.org/rcgp](http://www.ifc.org/rcgp)).

<sup>263</sup> LJSC, Article 70, Clause 2.

<sup>264</sup> FCSM Code, Chapter 4, Section 4.1.1.

The charter or by-laws must specify the procedures for convening and conducting Executive Board meetings.<sup>265</sup>

### 4. Meeting Notification

Since the Executive Board is a management tool, it will likely need to respond to the changing demands of the company and its external environment, and be prepared to act quickly. While rapid response is necessary, it may make careful and extensive preparation for meetings difficult and, in some cases, impossible. Obviously, Executive Board members should be as well prepared as practical. To the extent possible, they should be notified in advance to give them time to prepare in order to effectively participate in meetings.

**Best Practices:** Executives should not vote on agenda items unless they are well informed. Whenever possible, materials should be sent to Executive Board members in advance, together with the notice and the meeting agenda.<sup>266</sup> This may, however, not always be the case and, under some circumstances, sound decision-making may not be possible. Decision-making may be postponed when members:

- Cannot be notified in a timely manner; or
- Have not received the required information on time; or
- Have not been provided with sufficient time to prepare for the meeting.

The by-laws or other internal documents should determine the form in which notice and materials are to be delivered to Executive Board members in the most convenient and appropriate way.

### 5. The Quorum of Executive Board Meetings

The quorum of Executive Board meetings refers to the number of members that must participate in the meeting before it can make a valid decision. The charter or by-laws set the quorum, which cannot be less than one half of the total number of Executive Board members.<sup>267</sup> Any Executive Board meeting that lacks a quorum cannot make valid decisions.

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<sup>265</sup> LJSC, Article 70, Clause 1.

<sup>266</sup> FCSM Code, Chapter 4, Sections 4.1.3 – 4.1.4.

<sup>267</sup> FCSM Code, Chapter 4, Section 4.1.4.

### 6. Voting During Executive Board Meetings

A simple majority of Executive Board members who participate in the meeting is sufficient to approve Executive Board decisions, unless the charter or by-laws require a supermajority vote.<sup>268</sup> The Company Law does not however envisage a supermajority vote for any Executive Board decision.

The Company Law prohibits the transfer of the right to vote from one Executive Board member to another.<sup>269</sup> Each Executive Board member has one vote. The charter can specify that the Chairman of the Executive Board can cast a deciding vote in the case of a tie.

### 7. The Minutes of Executive Board Meetings

The Executive Board must keep minutes of each of its meetings.<sup>270</sup> The Company Law does not specify when the minutes must be prepared, though it stipulates that minutes must be kept in the company archives.<sup>271</sup>

**Best Practices:** The minutes of Executive Board meetings should include the following information:

- The location and time of the meeting;
- The names of the persons present at the meeting;
- The agenda of the meeting;
- The issues on the agenda, as well as the voting results on an individual basis;
- The decisions made by the Executive Board; and
- The rationale for the decisions.

The Chairman of the Executive Board must sign the minutes.<sup>272</sup>

The minutes of the Executive Board meeting must be made available upon the request of:

- Revision Commission members;
- The External Auditor;
- Supervisory Board members;<sup>273</sup> or

<sup>268</sup> LJSC, Article 70, Clause 2, Paragraph 1.

<sup>269</sup> LJSC, Article 70, Clause 2, Paragraph 4. See also: FCSM Code, Chapter 4, Section 4.1.6.

<sup>270</sup> LJSC, Article 70, Clause 2.

<sup>271</sup> LJSC, Article 89, Clause 1.

<sup>272</sup> LJSC, Article 70, Clause 2.

<sup>273</sup> LJSC, Article 70, Clause 2.

- A shareholder (or a group of shareholders) possessing at least 25% or more of voting shares.<sup>274</sup>

**Best Practices:** The minutes of the Executive Board should also be made available to the Control and Revision Service (Internal Audit Function) of the company.<sup>275</sup>

If the company does not have an Executive Board, the decisions of the General Director must also be kept in the company archives. The charter should, in such cases, describe the procedures for the General Director to file his decisions.

### E. The Duties and Liabilities of the Members of the Executive Bodies

The members of the executive bodies have the same duties of care and loyalty as Supervisory Board members, and are subject to the same liability standards as Supervisory Board members, unless either the charter, by-laws, or employment contract provide for stricter standards.

→ *For more information about the duties and liabilities of directors, see Chapter 4, Section F.*

### F. Performance Evaluations

Periodic performance evaluations of the executive bodies are an important oversight tool. They can help create a system of constant performance management and improvement.

**Best Practices:** The charter or by-laws can stipulate that the performance of the executive bodies be evaluated by the Supervisory Board at least annually, if not more frequently. The Supervisory Board may also find it useful to receive evaluations on the performance of the executive bodies that are carried out by the General Director and Executive Board members themselves, through self-evaluation within the framework of the company's HR performance evaluation and planning process.

→ *For an example of a self-evaluation framework, see Chapter 4, Section G.*

<sup>274</sup> LJSC, Article 91, Clause 1.

<sup>275</sup> FCSM Code, Chapter 4, Section 4.1.5.

## G. The Remuneration and Reimbursement of the Executive Bodies

The Company Law does not explicitly regulate who determines the remuneration of the executive bodies.

**Best Practices:** Executive remuneration is an important aspect in attracting managerial talent. Excessive executive remuneration packages on the other hand are often perceived as an unjustified privilege of power. Consequently, it is of the utmost importance that executive compensation be competitive, yet stay within reasonable limits, ideally in relation to a peer group of companies.

The remuneration of executive should not be left to the sole discretion of the executive bodies themselves.<sup>276</sup> This should fall under the Supervisory Board's authority.<sup>277</sup> Companies should state in their charters that the approval of executive remuneration is a prerogative of the Supervisory Board. It is important that the Supervisory Board take into consideration performance-related factors that are based on the company's key performance indicators when determining the remuneration of executives. Some of the issues that have a bearing on remuneration are:<sup>278</sup>

- Scope of responsibilities;
- Required type and level of qualifications;
- Experience of the candidates;
- Personal and business qualities of the candidates;
- Typical level of remuneration in the company and in the industry in general; and
- The financial performance of the company.

An executive's base salary is usually a function of his background and experience, whereas variable compensation is generally based upon the executive's performance.

<sup>276</sup> FCSM Code, Chapter 3, Section 1.4.3.

<sup>277</sup> FCSM Code, Chapter 1, Section 3.4.

<sup>278</sup> FCSM Code, Chapter 3, Section 4.10.2.

### 1. Remuneration Policy

The remuneration of managers can consist of both a fixed and a variable component.

The fixed component typically consists of a base salary. The most important factor in determining an executive's base salary is compensation practice among a peer group of similar companies.

The most important factor in determining an executive's variable remuneration is his contribution towards the short and long-term financial performance of the company. The variable component often consists of an annual bonus and is based on key performance indicators. Variable compensation has come to represent a large part of an executive's remuneration package in many countries, to better motivate performance.

**Best Practices:** The FCSM Code recommends that remuneration be based upon performance-related criteria.<sup>279</sup> There is a multitude of ways to link executive pay to individual and company performance. Some common financial indicators utilized in variable compensation plans are:

- Earnings before interest, taxes, depreciation and amortization (EBITDA);
- Operating profit;
- Return on Assets (ROA);
- Return on Investment (ROI) or Equity (ROE);
- Return on Capital Employed (ROCE);
- Economic Value Added (EVA); and
- Achievement of specific individual objectives.

There are many other financial indicators. Non-financial indicators are equally important and valuable in managing executive performance, and can be organized around:

- Customers — for example, customer satisfaction levels, retention rates and customer loyalty, and acquisition;
- Operational processes and efficiency — for example, quality measures, cycle time measures, cost measures, and after sales service; and
- Internal growth/knowledge management — for example, training programs, employee satisfaction rates, employee absenteeism, and employee turnover.

The Supervisory Board will want to carefully develop key performance indicators, and link executive remuneration to these indicators.

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<sup>279</sup> FCSM Code, Chapter 4, Section 5.1.2.



Moreover, executives often receive benefit plans consisting of a pension plan, medical and dental plan, savings plan, life insurance plan, and a disability plan.

Other prerequisites for senior executives include club memberships, use of a company car, chauffeurs, and similar perks.

Finally, some companies in western countries provide their executives with long-term incentive systems that may include stock options.

**Best Practices:** While remuneration is generally considered a responsibility of the Supervisory Board, stock- and option-based compensation is increasingly an issue for which shareholder approval is required. The reason is that equity compensation contains considerable hidden costs for shareholders. These costs are hidden since accounting practices do not generally reveal the true price-tag of option-based compensation plans. For this reason, more and more companies are attempting to disclose the true cost of option compensation. In addition, some exchanges such as the NYSE and the NASDAQ now require shareholder approval of all equity-based compensation plans.<sup>280</sup>

While remuneration plans may serve to attract top executive talent and motivate better performance, the field of executive remuneration is both complex and a lightning rod for shareholder and public criticism. Companies that introduce such plans, in particular stock-option plans, should do so with a good deal of circumspection and a maximum of transparency.

## 2. Employment Contracts for Executives

Legislation requires that the company conclude employment contracts with the General Director and Executive Board members.<sup>281</sup> These contracts must include:<sup>282</sup>

- The name of the General Director, or Executive Board member;
- The name of the company;
- The starting date of the contract;

<sup>280</sup> New York Stock Exchange Corporate Accountability and Listing Standards Committee, June 6, 2002.

<sup>281</sup> Labor Code, Article 275.

<sup>282</sup> Labor Code, Article 57.

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- The rights and duties of the General Director, or Executive Board member;
- The rights and duties of the company;
- Remuneration; and
- The term of the contract.

**Best Practices:** The contract should include additional items such as:

- Sanctions to be applied for failing to carry out one's responsibilities;
- Benefits and other privileges (e.g. discounts on purchases of company shares, health insurance, reimbursement for housing costs);
- Indemnification;
- Confidentiality clauses during the term of the contract and after the executive leaves the company regardless of the reason for leaving;
- Non-competition clauses during the service period and after the executive leaves the company for whatever reason;
- A commitment to protect the interests of the company and its shareholders; and
- Grounds for early termination.

The Company Law is not explicit with regard to who is responsible for negotiating contracts with members of the executive bodies.

**Best Practices:** The GMS is not expressly vested with the power to negotiate contracts. Good business sense and a reasonable interpretation of the Company Law suggest that the Supervisory Board should do so. At a minimum, good corporate governance practices would require the Supervisory Board to approve contracts with members of the executive bodies.

Regardless, executives should never determine their own remuneration. The Supervisory Board and, ideally, an independent Remuneration Committee should do so. To avoid potential conflicts of interest, executive directors should not vote on their own employment contracts.<sup>283</sup> In summary, it is recommended that:

- Executive directors be counted for the quorum of the Supervisory Board; and
- The votes of executive directors not be counted when approving the terms and conditions of their own employment contracts.

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<sup>283</sup> FCSM Code, Chapter 3, Section 1.4.3.

### 3. Severance Payments to the General Director and Executive Board Members

Executives may, under certain circumstances, be dismissed without cause and yet receive severance payments. This may occur when a company has been acquired and the acquirer wishes to install new management. These severance plans are sometimes referred to as golden parachutes. Golden parachutes can be defined as a clause in an executive's employment contract specifying that he will receive large benefits in the event that the company is acquired and the executive's employment is terminated. These benefits can take the form of severance pay, a bonus, stock options, or a combination thereof. Like other forms of compensation, golden parachutes are often the object of criticism.

Severance agreements may, however, be in the interest of shareholders since they can avoid prolonged and costly litigation and public relations problems. Nevertheless, caution should be applied when putting them in place, and the assistance of competent outside advisors should be sought. The approval of severance payments should be a priority for the Supervisory Board and, possibly, the GMS.

**Best Practices:** The FCSM Code recommends that the employment contracts of the General Director and Executive Board members include a provision for severance payments when their employment contracts are terminated prematurely.<sup>284</sup>

<sup>284</sup> FCSM Code, Chapter 4, Section 5.1.3.