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

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

Anne Simpson, Manager,
Global Corporate Governance Forum

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

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

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

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

Questions on corporate governance
should be addressed to the
IFC Russia Corporate Governance Project, via
CGPRussia@ifc.org

An electronic version of the Manual
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and the
U.S. Department of Commerce under
www.mac.doc.gov/ggp

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The Russia Corporate Governance Manual

III Part III Shareholder Rights

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

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

EVD international business and cooperation
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Государственный Секретариат
Швейцарии по Экономике
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State Secretariat for Economic Affairs
seco

The Russia **Corporate Governance** Manual

Part III

Shareholder Rights

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

In Partnership with the Agency for International Business
and Cooperation of the Dutch Ministry of Economic Affairs
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Chapter 7

An **Introduction** to **Shareholder Rights**

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The Chairman's Checklist

- ✓ Does the company charter protect shareholder rights as stipulated by the Company Law and recommended by the Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code)? Do all directors take appropriate measures to ensure that these rights are respected?
- ✓ Do all directors take measures to encourage shareholders to exercise their rights, in particular, the right to vote? Do shareholders exercise their rights collectively?
- ✓ Does the Supervisory Board provide shareholders with free access to company information beyond the requirements of the Company Law? Are shareholder requests processed properly and on time?
- ✓ Does the Supervisory Board ensure that an independent External Registrar maintains the shareholder register? Are shareholders provided with full and accurate information regarding their account from the Registrar?
- ✓ Does the Supervisory Board encourage shareholders to protect their rights by using all the mechanisms provided by legislation and the FCSM Code?
- ✓ Does the Supervisory Board ensure that the charter and other internal documents do not stipulate obligations of shareholders other than the ones that are clearly defined by the Company Law?

Shareholders rely on the rights they receive in return for their investment. For most shareholders, this includes the right to participate in the profits of the company. Other rights are also important, such as the right to vote on the Supervisory Board's composition, approve charter amendments and capital changes, approve the annual report and financial statements, and the right to access information about the company and its activities. Through these rights, shareholders ensure that the managers of the company do not misappropriate their investment.

The quality of investor protection has several corporate governance implications, such as the depth of capital markets, ownership patterns, dividend policy, and the efficiency of allocating resources.[1] Where laws are protective of shareholders and well enforced, shareholders are willing to invest their capital, and financial markets are broader and more valuable. In contrast, where laws do not adequately protect shareholders, the development of financial markets is stunted. When shareholder rights are protected by the law, and indeed by the company itself, outside investors are willing to pay more for financial assets such as equity. They pay more because they recognize that, with better legal protection, more of the firm's profit will return to them as dividends and/or capital gains as opposed to being expropriated by managers or controlling shareholders.

The mere "law on the books" is not necessarily sufficient to ensure that shareholder rights are adequately protected. Effective enforcement is also required. Tantamount to shareholder rights protection is the company's behavior itself — especially for Russian companies that do not benefit from an effective enforcement regime and continue to be blemished by the many corporate governance scandals during the privatization years.

This chapter provides an overview of shareholder rights and the rules a company must follow to protect these rights. Some specific rights, such as the participation in the General Meeting of Shareholders (GMS), are discussed in detail in other chapters of this Manual.

A. General Provisions on Shareholder Rights

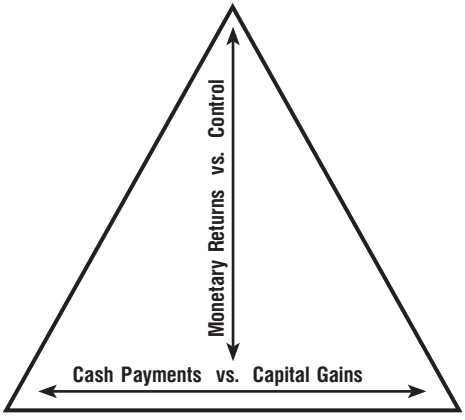
1. Reasons for Being a Shareholder

Investors purchase company shares for a variety of reasons. The most common reasons are shown in Figure 1.

[1] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, Robert Vishny, Investor Protection and Corporate Valuation, National Bureau of Economic Research, Working Paper 7403, October 1999.

Figure 1: Common Reasons for Becoming a Shareholder

Control: Shares provide investors with the opportunity to legally control the company and influence decision-making by nominating directors and, possibly, management. The greater the number of voting shares a shareholder holds, the greater the influence he wields.



Dividends: Dividends play an important role in the decision to invest. Regular dividend payments, especially if an investor holds a portfolio of shares, can generate predictable cash flows.

Capital Gains: Investors purchase shares to benefit from capital growth. Unlike dividends, shares need to be sold to realize the gains represented by rising share prices.

Source: IFC, March 2004

2. Types of Shares

Legislation specifies two types of shares: common and preferred. A company is required to issue common shares.[2] In addition, a company may also issue preferred shares.

➜ *For more information on charter capital and shares, see Chapters 9 and 11.*

a) Common Shares

Owners of common shares have the right to participate in the decision-making of the company, most commonly exercised by voting during the GMS. They also have the right to share in the profits of the company either through dividends or through capital gains.

[2] Law on Joint Stock Companies (LJSC), Article 25, Clause 2, Paragraph 1.

Common shares have certain characteristics. The charter defines the number, nominal value, and rights attached to common shares.[3] The aggregate nominal value of all issued common shares cannot be less than 75% of the charter capital.[4] All common shares must have the same nominal value and must provide the same rights to their owners. Common shares cannot be divided into different classes or be converted into other securities of the company.[5]

b) Preferred Shares

A company has the right to issue various classes of preferred shares. The total nominal value of preferred shares of all classes cannot exceed 25% of the charter capital.[6] All preferred shares of the same class must have the same nominal value and must provide the same rights to their owners.[7] In contrast to common shares, preferred shares can be divided into classes depending on the rights and preferences attached to them.

Preferred shares can give their owners preferential rights associated with the distribution of dividends, liquidation value of shares, and voting rights attached to shares under specific circumstances.

The charter must specify the number of preferred shares issued by the company, as well as the nominal value and rights attached to preferred shares. In addition, the charter must specify the amount of dividends and/or the liquidation value of preferred shares or, alternatively, the procedure for determining the amount of dividends and the liquidation value of preferred shares.[8]

The charter can provide preferred shareholders of a specific class with the opportunity to convert their shares into common shares or other classes of preferred shares.[9]

The Company Law distinguishes preferred shares according to the dividend rights that they grant:[10]

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[3] LJSC, Article 11, Clause 3; Article 27, Clause 1.

[4] LJSC, Article 25, Clause 2.

[5] LJSC, Article 31, Clauses 1 and 3.

[6] LJSC, Article 25, Clause 2.

[7] LJSC, Article 32, Clause 1, Paragraph 2.

[8] LSJC. Article 32, Clause 2.

[9] LJSC, Article 32, Clause 3, Paragraph 1.

[10] LJSC, Article 32, Clause 2, Paragraph 3.

- **Cumulative:** the charter can provide that unpaid dividends be accumulated and paid on a later date; and
- **Non-cumulative:** if the charter is silent, unpaid dividends shall not be accumulated.

The principal differences between common and preferred shares are summarized in Figure 2.

Figure 2: Comparison of Common and Preferred Shares

	Common Shares	Preferred Shares
Mandatory	**Yes**, must always be issued	**No**, are optional
What is the percentage of shares that can be issued?	A **minimum of 75%** of the charter capital is mandatory	A **maximum of 25%** of the charter capital is allowed
Can different classes of shares be issued?	**No**, only one class of common shares may be issued	**Yes**, different classes of preferred shares can be issued
Can this type of share be converted into other securities?	**No**, common shares cannot be converted into preferred shares or other securities	**Yes**, preferred shares may be converted into common shares, if so provided for in the charter
Do shareholders have the right to vote during the GMS?	**Yes**, with certain exceptions	**No**, except under certain circumstances. ➜ **See Section B.1 of this Chapter**
Can the charter grant additional rights to shareholders?	**Yes**	**Yes**

Source: IFC, March 2004

c) Voting Shares

The Company Law also defines the term "voting share." Common shares are always voting shares. Preferred shares can be voting shares under certain circumstances.[11]

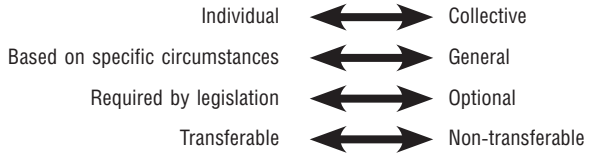
➜ *For more information on voting shares, see Chapter 8, Section C.11.*

[11] LJSC, Article 49, Clause 1, Paragraph 2.

3. Types of Shareholder Rights

The Company Law distinguishes between the rights of individual shareholders and the rights held collectively by a group of shareholders. It is also possible to distinguish shareholder rights according to their nature. Some rights relate to the decision-making process and the organization of the company. Others relate to the capital and the return on shareholder investment (see Figure 3).

Figure 3: The Two-Sided Nature of Shareholder Rights



Source: IFC, March 2004

Figure 4 summarizes the rights of shareholders by types of shares, and by the percentage of shares held. Neither the company nor its shareholders can change these rights. The charter can, however, provide additional rights to shareholders as long as they are not prohibited by legislation.

B. Specific Shareholder Rights

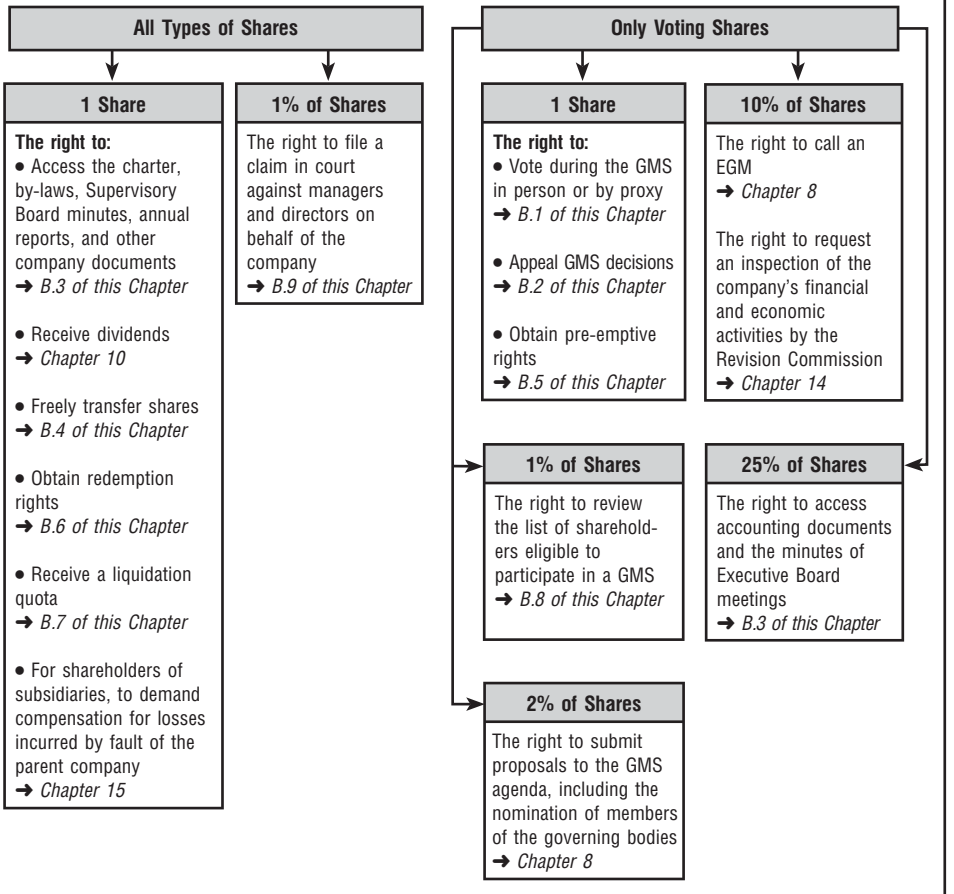
1. The Right to Vote

Shareholders can participate in the decision-making of the company through their right to vote during the GMS. Shareholders can, for example, control the long-term direction of the company by electing Supervisory Board members and by deciding on important matters that fall within the authority of the GMS.

The right to vote can be exercised personally or by a power of attorney.[12] A power of attorney provides its authorized holder (proxy) with the right to act on behalf of the shareholder and to make any decision the shareholder could have

[12] LJSC, Article 57, Clauses 1–2.

Figure 4: Shareholder Rights Under the Company Law



Source: IFC, March 2004

made during the GMS. Except for limitations provided by legislation,[13] any individual can serve as a proxy as long as this person is given a written and duly executed power of attorney.

➜ *For more information on the GMS, see Chapter 8.*

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

a) The Right to Vote Common Shares

Common shares grant voting rights to their holders. However, there are some circumstances when common shares become non-voting. These circumstances are summarized in Table 1.

Table 1: Non-Voting Common Shares

Preconditions	Legal Consequences
Failure to fully pay for shares: When common shares placed to the company's founders are not fully paid for, unless the charter provides otherwise.	Precludes voting on any issue during the GMS[14]
Limitations on the number of votes and/or shares that a single shareholder can possess: When a shareholder has more votes than the maximum established by the charter that can be used during the GMS	Precludes casting more than the maximum number permitted by the charter on any issue during the GMS[15]
Treasury shares:[16] When the company possesses issued common shares of the company because: • The founders have not fully paid the shares within the period that they have to fully pay the common shares; or • The company redeemed common shares; or • The company fought back common shares.	Precludes voting on all issues during the GMS
The approval of related party transactions: Common shares that are owned by a shareholder who is an interested party in a related party transaction.	Precludes voting on the approval of the related party transaction in which the shareholder is an interested party[17]
Waiver to extend the buy-out offer in control transactions: • When common shares are owned by a controlling shareholder, including his affiliated parties; and • When the company has more than 1,000 common shareholders. ➜ *See Chapter 12.*	Precludes voting on the waiver of the controlling shareholder's obligation to buy-out the minority shareholders[18]

[14] LJSC, Article 34, Clause 1, Paragraph 3.

[15] LJSC, Article 11, Clause 3.

[16] LJSC, Article 34, Clause 1, Paragraph 5; Article 72, Clause 3, Paragraph 2; Article 76, Clause 6, Paragraph 2. Shares are commonly reacquired by a corporation to be retired or resold at a later date. Treasury shares are issued, but not outstanding, and are not taken into consideration when calculating earnings per share or dividends, or for voting purposes.

[17] LJSC, Article 83, Clause 4.

[18] LJSC, Article 80, Clause 2, Paragraph 2.

Table 1: Non-Voting Common Shares	
Preconditions	**Legal Consequences**
Violation of rules on the acquisition of shares in control transactions: • When a person (or a group of affiliated persons) acquires common shares that are equal to or exceed a total of 30% of common shares; and • When this person (or this group of affiliated persons) has not followed the procedures specified by the Company Law when acquiring these shares; and • When the company has more than 1,000 common shareholders.	Common shares (the acquired shares that cause the holdings to equal or exceed 30%) cannot be voted at the GMS[19]
Violation of rules on the acquisition of shares in control transactions: • Each time a person (or a group of affiliated persons) acquires 5% of common shares; and • This person (or this group of affiliated persons) already possesses at least 30% of common shares; and • When this person (or this group of affiliated persons) has not followed the procedures specified by the Company Law when acquiring the additional 5% of common shares; and • When the company has more than 1,000 common shareholders.	Precludes voting on all issues during the GMS[20]
Election and dismissal of Revision Commission members: When common shares are held by Supervisory Board members, the General Director, and Executive Board members.	Precludes voting on the election of Revision Commission members[21]

b) The Right to Vote Preferred Shares

The Company Law limits the right of preferred shareholders to participate in voting during the GMS. Preferred shareholders normally do not have voting rights at the GMS except under specific circumstances when their rights are affected. These circumstances are summarized in Table 2.

[19] LJSC, Article 80, Clause 6.

[20] LJSC, Article 80, Clause 7.

[21] LJSC, Article 85, Clause 6, Paragraph 2.

Table 2: When Preferred Shares Become Voting Shares	
Circumstances	**When Owners of Preferred Shares Can Vote**
Reorganization or liquidation	The owners of preferred shares can vote on agenda items that are directly related to the reorganization and liquidation of the company[22]
Charter amendments that restrict preferred shareholder rights of a specific class	The owners of preferred shares of a specific class can vote on charter amendments restricting the rights attached to preferred shares of that specific class[23]
Non-declaration of dividends on non-cumulative preferred shares	The owners of non-cumulative preferred shares have the right to vote on all agenda items during the GMS until the first payment of dividends is made in full[24]
Partial payment of dividends on non-cumulative preferred shares	The owners of non-cumulative preferred shares have the right to vote on all agenda items during the GMS until the first payment of dividends is made in full[25]
Non-declaration of dividends on cumulative preferred shares	The owners of cumulative preferred shares have the right to vote on all agenda items during the GMS until the full payment is made of all accumulated dividends[26]
Partial payment of dividends on cumulative preferred shares	The owners of cumulative preferred shares have the right to vote on all agenda items during the GMS until the full payment is made of all accumulated dividends[27]

2. The Right to Appeal Decisions of the General Meeting of Shareholders

A shareholder has the right to appeal decisions of the GMS in court when:[28]

- The decision is adopted in violation of legislation or charter provisions; and
- The decision violates the rights and lawful interests of the shareholder; and

[22] LJSC, Article 32, Clause 4, Paragraph 1.

[23] LJSC, Article 32, Clause 4, Paragraph 2.

[24] LJSC, Article 32, Clause 5, Section 1.

[25] LJSC, Article 32, Clause 5, Section 1.

[26] LJSC, Article 32, Clause 5, Section 2.

[27] LJSC, Article 32, Clause 5, Section 2.

[28] LJSC, Article 49, Clause 7.

- The shareholder did not participate in the GMS or voted against this decision of the GMS.

A shareholder appealing a decision of the GMS must file his appeal with the court within six months after the shareholder learned or should have learned about the decision.[29]

➜ *For more information on appealing decisions of the GMS, see Chapter 8, Section E.5 and Part V, Chapter 17, Section B.*

3. The Right to Receive Information About the Company

The Company Law provides shareholders with the right to receive information about the company based on the percentage of shares held. Distinctions are made between any shareholder and a shareholder (or a group of shareholders) owning at least 25% of voting shares.

Any shareholder has the right to receive information about the activities of a company. The charter and by-laws can specify the procedures that the company and shareholders must follow for the distribution of information and documents. The information rights of common and preferred shareholders are depicted in Figure 5.[30]

A company must also provide shareholders (or a group of shareholders) holding at least 25% of voting shares access to the:[31]

- Accounting documents;[32] and
- Minutes of the Executive Board meetings.

The company must provide shareholders the opportunity to familiarize themselves with the above-mentioned documents at the premises of the company within seven days after a request was received.[33]

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[29] LJSC, Article 49, Clause 7.

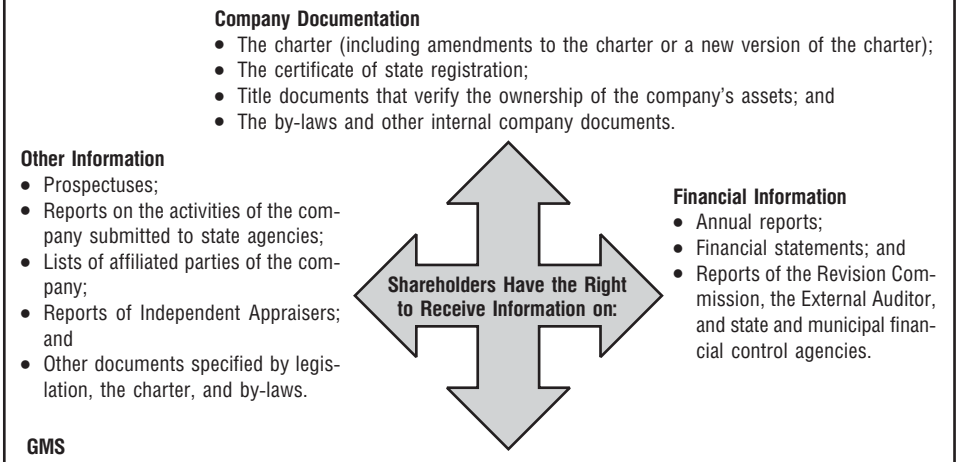
[30] LJSC, Article 89, Clause 1; Article 91.

[31] LJSC, Article 91, Clause 1, Paragraph 1.

[32] The Company Law is not clear about the definition of "accounting documents." The primary accounting documents (which serve as the basis for the balance sheet and other financial statements) could be considered "accounting documents" pursuant to LJSC, Article 91, Clause 1, Paragraph 1. However, the primary accounting documents are also defined as confidential commercial information in accordance with the Law on Accounting, Article 9.

[33] LJSC, Article 91, Clause 2.

Figure 5: Shareholder Information Rights



Source: IFC, March 2004

Best Practices: It is good practice to provide the requested documents to the shareholders for their examination at the company's premises within five days after the request is received.[34]

Upon the request of any shareholder, a company must also provide a copy of documents specified in Figure 5.[35]

Best Practices: Although the Company Law does not provide a specific time frame within which copies must be given to shareholders, it is recommended that this be done within five days.[36]

[34] Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), Chapter 7, Section 3.1.1.

[35] LJSC, Article 91, Clause 2. The LJSC is not clear when the company must provide copies of these documents to shareholders.

[36] FCSM Code, Chapter 7, Section 3.1.1.

The company cannot charge shareholders more than the actual costs of copying the requested documents.[37]

➜ *For more information on information disclosure, see Part V, Chapter 13.*

4. The Right to Freely Transfer Shares

The owners of common and preferred shares of a company have the right to sell their shares at any time and at any price, without the consent of, or any pre-emptive right on the part of, the company and other shareholders.[38] This means that the company cannot restrict the free transferability of shares, regardless of type and class. Any charter provisions purporting to restrict the transferability of common and preferred shares are null and void.[39]

➜ *For more information on the transfer of shares, see also Chapter 11.*

5. Pre-Emptive Rights

In certain circumstances, shareholders have pre-emptive rights, which allow them to purchase shares or convertible securities on a priority basis before they are offered to third parties. Thus, a shareholder has the right to purchase newly issued shares in proportion to the number of shares he owns at the time the company decides to issue new shares or convertible securities of the same type and class.[40]

The pre-emptive rights of shareholders cannot be detached from shares. This means that a shareholder cannot transfer his pre-emptive rights to another shareholder. Pre-emptive rights are only transferable together with shares.

a) The Purpose of Pre-Emptive Rights

Pre-emptive rights ensure that all shareholders of the same class are treated equally. They provide the opportunity to purchase new shares when the company wants to increase its charter capital. Pre-emptive rights help protect shareholders from dilution, which can result in losing some of their rights due to the decrease of the percentage of shares they hold.

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[37] LJSC, Article 91, Clause 2.

[38] Note that this Manual refers to open joint stock companies.

[39] LJSC, Article 7, Clause 2, Paragraph 3.

[40] LJSC, Article 40, Clause 1.

b) When Pre-Emptive Rights Exist

The existence of pre-emptive rights depends on the type of subscription (open or closed) and whether it is limited to the existing shareholders or whether third parties can purchase new shares. Figure 6 specifies the cases in which shareholders have pre-emptive rights.

Figure 6: When Pre-Emptive Rights Exist

Open Subscription	Closed Subscription (Shareholders and Third Parties)	Closed Subscription (Only Shareholders)
Each shareholder can purchase a number of shares and other convertible securities pro rated to the number of shares that he already owns.	Only the shareholder who has voted against the decision to carry out a closed subscription, (or who did not participate in the voting on that issue) can purchase a number of shares and other convertible securities pro rated to the number of shares that he already owns.	No pre-emptive rights exist if new shares and convertible securities are issued through closed subscription only to shareholders and if such shareholders have the option to purchase newly issued shares and other convertible securities pro rated to the number of shares they already own.

Source: IFC, March 2004

➜ *For more information on open and closed subscriptions, see Chapter 9, Section B.3.*

c) Pre-Emptive Rights and Fractional Shares

When shareholders exercise pre-emptive rights, fractions of shares (fractional shares) can result.[41]

A fractional share provides its owner a fraction of the rights attached to the full share of the specific type and class. For purposes of calculating the amount of the charter capital, all fractional shares must be added together. If, as a result,

[41] LJSC, Article 25, Clause 3, Paragraph 1. For example, shareholder A has 123 common shares out of 1,000 common shares, which represent 12.3% of all common shares. If the company is placing 250 additional common shares, shareholder A will be entitled to purchase 12.3% of 250 shares or 30.75 shares.

a fractional share is left, the number of issued shares in the charter must indicate the fraction of a full share.[42]

Fractional shares circulate together with full shares. If a shareholder acquires two or more fractional shares of the same type and class, these shares must be added together to create one full and/or one fractional share which is equal to the sum of these fractional shares.[43]

d) The Procedure for Exercising Pre-Emptive Rights

The list of shareholders with pre-emptive rights must be compiled based on the shareholder register as of the date of the decision to issue additional shares or other convertible securities. The shareholders included in the shareholder list that have pre-emptive rights must be notified in the same manner as the notification of the GMS.[44] This notification must include information on:[45]

- The number of shares or convertible securities to be issued;
- The placement price or the procedure for determining the placement price (including the placement price or the procedure for determining the placement price of additionally issued shares for shareholders with pre-emptive rights);
- The procedure for determining the number of shares and convertible securities that each shareholder has the right to purchase; and
- The period within which pre-emptive rights must be exercised.[46]

A shareholder that has pre-emptive rights can exercise these rights fully or in part by submitting to the company:[47]

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[42] LJSC, Article 25, Clause 3, Paragraph 3. If shareholder A owns 12.3 shares, shareholder B 34.5 shares, shareholder C 40.6 shares, and the remaining shareholders collectively own 50 shares, the charter must state the following number of issued shares of the company: 12.3 + 34.5 + 40.6 + 50 = 137.4 shares.

[43] LJSC, Article 25, Clause 3, Paragraph 4. For example, shareholder A purchases one fractional share of 0.3 and the second fractional share of 0.6. As the result, shareholder A has one fractional share of 0.9.

[44] LJSC, Article 41, Clause 1, Paragraph 1. *See also: Chapter 8, Section B.4.*

[45] LJSC, Article 41, Clause 1, Paragraph 2.

[46] LJSC, Article 41, Clause 1, Paragraph 2 provides that this period cannot be less than 45 days from the date of submitting (presenting in person) or publishing the notification on pre-emptive rights. Before the expiration of this period, the company does not have the right to issue shares and other convertible securities to persons other than the shareholders who have pre-emptive rights.

[47] LJSC, Article 41, Clause 2, Paragraph 1.

- A written statement requesting the purchase of additionally issued shares or other convertible securities, which must include:
  - The name of the shareholder,
  - The place of residence (location) of the shareholder, and
  - The number of shares or convertible securities to be purchased by the shareholder; and
- A document verifying the payment for shares or other convertible securities.

If the placement of additional shares and other convertible securities calls for payment in-kind, the Company Law also grants shareholders with pre-emptive rights the right to pay in monetary form.[48]

6. The Right to Demand the Redemption of Shares

A shareholder has the right to have the company redeem all or a part of his shares when the company:[49]

- Reorganizes, and the shareholder voted against the decision or did not participate in the voting on this decision during the GMS;
- Concludes an extraordinary transaction approved by a decision of the GMS and the shareholder voted against this decision or did not participate in the voting on this decision;[50] or
- Adopts a new version of the charter or amends the charter by a decision of the GMS, which limits the rights of the shareholder, and the shareholder voted against this decision or did not participate in the voting on this decision.

To exercise his redemption rights, a shareholder must be informed about the right to demand the redemption of his shares. The notice of the GMS that must approve the decisions that can trigger the redemption rights must include the following information about the redemption rights:[51]

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[48] LJSC, Article 41, Clause 2, Paragraph 2.

[49] LJSC, Article 75, Clause 1.

[50] LJSC, Article 75, Clause 1 provides that redemption rights arise only when the extraordinary transaction involves assets, the value of which is 50% or less of the book value of the company's assets. However, the Plenum of the Supreme Arbitration Court has interpreted this provision to include extraordinary transactions involving assets with a value of more than 50% of the book value of company's assets; see Resolution No. 19, the Plenum of the Supreme Arbitration Court, on Some Issues of Application of the Federal Law on Joint Stock Companies, 18 November 2003, Section 29.

[51] LJSC, Article 76, Clauses 1 and 2.

- The right of shareholders to demand the redemption of all or part of their shares if they vote against or do not participate in the voting on specified agenda items;
- The redemption price the shareholders will receive if they demand redemption; and
- The procedure for exercising redemption rights.

The Supervisory Board must determine the redemption price, which cannot be less than the market value of shares to be redeemed as determined by an Independent Appraiser.

Shareholders have the right to submit a written request to the company to have their shares redeemed, which shall be done no later than 45 days after the GMS has approved the decision that gave rise to redemption rights.[52] The request must contain the following information:[53]

- The address of the shareholder who is demanding the redemption of his shares; and
- The number of shares the shareholder wants to redeem.

After the period for submitting requests for redemption has expired, the company must redeem the shares within 30 days.[54] The steps required to redeem shares are summarized in Figure 7.

7. Shareholder Rights During the Liquidation of the Company

Shareholders are residual claimants when a company is being liquidated, i.e. they will receive a portion of the assets remaining after creditor claims are satisfied. Owners of common shares have a right to receive a portion of the company's property in proportion to their holdings in the company. Owners of preferred shares have a right to receive the liquidation value of their preferred shares. The charter must determine the liquidation value for each class of preferred shares.

If the company has placed preferred shares of two or more classes, the charter must specify the priority of claims for each class of preferred shares.[55]

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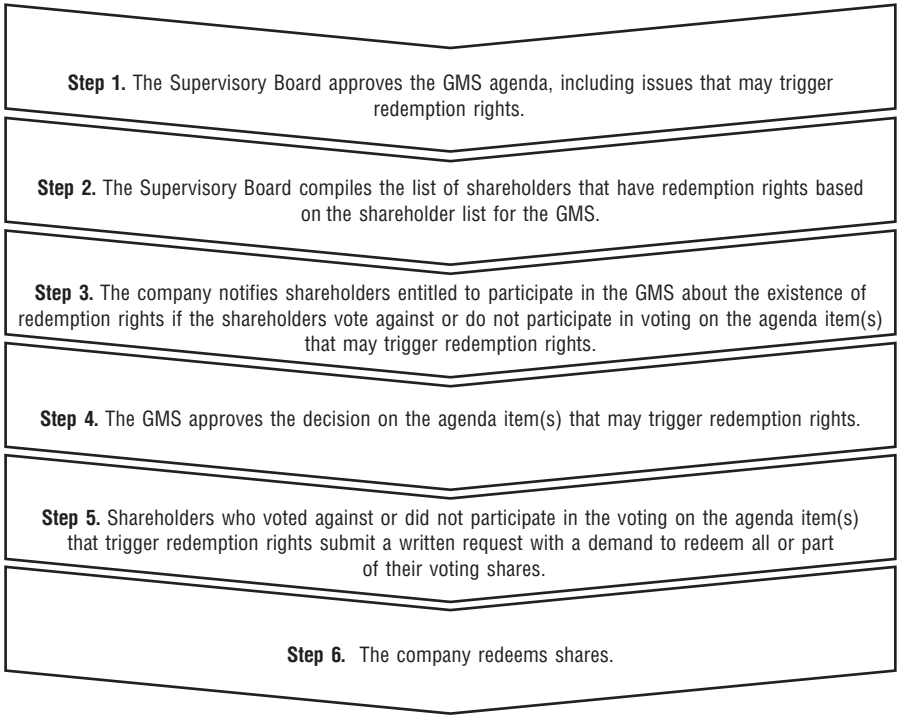
[52] LJSC, Article 76, Clause 3, Paragraph 2.

[53] LJSC, Article 76, Clause 3, Paragraph 1.

[54] LJSC, Article 76, Clause 4.

[55] LJSC, Article 32, Clause 2.

Figure 7: Procedures for Redemption



Source: IFC, March 2004

During liquidation, a company must first satisfy its obligations to creditors; then priority claimants (usually administrative expenses and salaries, wages, employee benefits, customer deposits, and taxes); and finally, the Creditors Committee divides the remaining assets among the shareholders following a specific order of priority:[56]

1) Common and preferred shareholders that can exercise redemption rights have the first priority to exercise their rights;
2) Second priority is given to preferred shareholders for the payment of declared but unpaid dividends on preferred shares and to the payment of the liquidation value of preferred shares as specified by the charter; and

[56] LJSC, Article 23, Clause 1.

3) The claims of the other shareholders with common shares and preferred shares without a liquidation value are satisfied after the first and second priorities.

The company's assets must be distributed to each group in order of priority. For example, the company cannot pay the liquidation value of preferred shares until it has paid the full liquidation value of higher priority shares.

If the company does not have sufficient assets to pay all shareholders of the same priority class, then the assets must be distributed in proportion to the number of shares in the class.

8. The Right to Review the Shareholder List

The company must give registered shareholders holding at least 1% of voting shares the opportunity to inspect the shareholder list within three days of a request.

This right gives shareholders the opportunity to contact other shareholders and coordinate voting for collective action purposes. It is also important for verifying the information in the shareholder list, as well as exercising rights attached to shares.

The company is obliged to provide the following information:[57]

- The shareholder list; or
- A document confirming that the inquiring shareholder is not included in the shareholder list.

In order to protect the privacy of shareholders, the company is not allowed to provide passport data and postal addresses to third parties without the shareholder's prior consent.

9. The Right to File a Claim on Behalf of the Company

A shareholder (or a group of shareholders) holding at least 1% of common shares has the right to file a claim with the court on behalf of the company to recover losses caused by:[58]

- A Supervisory Board member;
- The General Director;

[57] LJSC, Article 51, Clause 4.

[58] LJSC, Article 71, Clauses 2 and 5.

- An Executive Board member; and/or
- The External Manager.

➜ *For more information on the liability of directors and managers, see Part II, Chapter 4, Section F, and Chapter 5, Section E, respectively.*

C. The Rights of the State as a Shareholder

The state can participate in a company either as an ordinary shareholder or as the holder of a "golden share." A golden share can be established to ensure the security of the state, or protect the morale, health, rights, and interests of its citizens.[59] Golden shares give agencies and subdivisions of the Russian Federation the right to:[60]

- Propose items for the agenda of the GMS;
- Request an Extraordinary General Meeting of Shareholders (EGM);
- Veto the following decisions of the GMS:
  - — Amendments to the charter or approval of a new charter,
  - — Reorganization of the company,
  - — Liquidation of the company, appointment of the Creditors Committee, or approval of the intermediary and final liquidation balance sheets,
  - — Amendments to the charter capital, and
  - — Approval of extraordinary and related party transactions; and
- Access all corporate documents.

The holder of a golden share may appoint a representative to the Supervisory Board and the Revision Commission. The representative can be replaced at any time by the body that appointed the representative. The representative is considered an official Supervisory Board or Revision Commission member.

Golden share rights can be established in the following circumstances:[61]

- Upon the privatization of assets of "a unitary enterprise;"[62] or
- Upon the removal of a company from the government list of strategic companies irrespective of the number of state-owned shares.

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[59] Law on the Privatization of State and Municipal Property, Article 38, Clause 1, Paragraph 1.

[60] Law on the Privatization of State and Municipal Property, Article 38, Clause 3.

[61] Law on the Privatization of State and Municipal Property, Article 38, Clause 1.

[62] For more details about 'unitary enterprises', see CC, Article 113.

The special rights under a golden share arrangement can be exercised starting from the moment when the state sells 75% of its shares in the company.[63]

Best Practices: Although present in some other developed European countries, (foreign) investors are usually cautious about investing in companies with golden shares. Despite the fact that golden share arrangements can play a useful role in protecting the interests of the state and the public, it is recommended that state agencies carefully weigh all the pros and cons of implementing golden share arrangements for each company.

Golden shares are terminated by a decision of the body that made the decision to introduce them.[64]

The Russian Federation, state agencies, and municipal entities can be shareholders without a golden share arrangement. In this case, their rights are identical to the rights of the company's other shareholders.

D. The Shareholder Register

The shareholder register is an important document that identifies the shareholders and the owners of other registered securities of the company. It can be used to verify the number, nominal value, types, and classes of shares and other registered securities held. The shareholder register is also maintained to secure shareholder rights, and to monitor the circulation of shares and other registered securities.

1. Maintaining the Shareholder Register

Companies must have a shareholder register that is either maintained by the company itself or an External Registrar.[65] The Registrar is a professional company which maintains shareholder registers pursuant to a contract with companies. In companies with more than 50 shareholders, an External Registrar must maintain the shareholder register.[66]

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[63] Law on the Privatization of State and Municipal Property, Article 38, Clause 5, Paragraph 1.

[64] Law on the Privatization of State and Municipal Property, Article 38, Clause 5, Paragraph 2.

[65] LJSC, Article 44, Clause 3, Paragraph 1.

[66] LJSC, Article 44, Clause 3, Paragraph 2.

A company that has transferred the register to an External Registrar remains liable for its proper maintenance and safekeeping.[67]

If a company decides to change its External Registrar, it must either place an announcement in the media or inform all holders of securities in writing. The company must pay for the costs of the announcement.[68]

2. The Contents of the Shareholder Register

The shareholder register must include information about the:[69]

- Company that has issued securities;
- External Registrar (its branches and transfer agents), if the company uses a Registrar;
- Securities issued by the company;
- Persons (owners and nominal shareholders) and number, nominal value, and state registration number of securities of each type and class placed by the company that such persons own; and
- Details about the personal accounts of registered persons and transactions with securities requiring registration in such personal accounts.

Information about registered persons must include:

- Family name, first name, mailing address, and passport data of individuals; and
- Full company name, bank account number, mailing address of the legal entities, as well as the name of the registration agency, and the date and the serial number of the company's registration.

The company cannot be held liable for any losses caused to shareholders and owners of other securities if they fail to submit the necessary information for inclusion in the shareholder register.[70]

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[67] LJSC, Article 44, Clause 3, Paragraph 4.

[68] Law on the Securities Market, Article 8, Clause 3.

[69] LJSC, Article 44, Clause 1. See also: FCSM Regulation No. 27 on the Maintenance of the Register of Holders of Securities, Section 3 for more information that must be included in the shareholder register.

[70] LJSC, Article 44, Clause 5.

3. Accessing the Shareholder Register

The following parties have access to the shareholder register:

- The company;
- Owners of securities and nominal shareholders registered in the shareholder register; and
- State agencies, in cases specified by legislation.[71]

Although the company has the right to obtain information from the shareholder register, it does not have the right to disclose this information. Owners of registered securities and nominal shareholders are entitled to obtain information related to their personal accounts. They do not have the right to receive information related to other owners of securities of the company.

A shareholder or a nominal shareholder can receive information from the shareholder register in the form of an extract from his personal account. The extract must be provided upon the request of the shareholder or his representative within five working days.[72] Information that must be included in the extract from the personal account is specified by legislation.[73]

The entity that maintains the shareholder register of the company is liable for the completeness and reliability of the information specified in the extract.[74]

E. The Protection of Shareholder Rights

The protection of shareholder rights lies at the center of corporate governance and is of particular importance for companies operating in emerging markets or transition economies. This protection is realized both internally, i.e. through internal corporate procedures and other guarantees envisaged by the Company Law and other legislation, and externally, i.e. through outside parties.

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[71] FCSM Regulation No. 27, on the Maintenance of the Register of Holders of Securities, Section 7, Clause 7.9.3.

[72] Law on the Securities Market, Article 8, Clause 3.

[73] FCSM Regulation No. 27, on the Maintenance of the Register of Holders of Securities, Section 3, Clause 3.4.4.

[74] Law on the Securities Market, Article 8, Clause 3.

1. Guarantees in the Company Law

The Company Law provides many guarantees to realize and protect shareholder rights. Some of these guarantees are procedural in nature and relate to the organization of the GMS. Others are reflected in the respective obligations of the governing bodies and officers of the company, i.e. Supervisory Board members, the General Director, and Executive Board members.

Best Practices: It is important for the charter to ensure that shareholder rights, and the mechanisms designed to ensure and protect these rights, are clearly defined.

➜ *See also the model charter and company-level corporate governance code in Part VI, Annexes 2 and 4.*

For example, the right of shareholders to make proposals to the GMS agenda is guaranteed by the following provisions of the Company Law related to the authority and obligations of the Supervisory Board:[75]

- Directors cannot reject proposals on other than procedural grounds envisaged by the Company Law, thus preventing the removal from the agenda of questions that directors simply do not wish to address;
- Directors have to provide reasons when rejecting a proposal;
- Directors are required to review the proposal within a strictly defined timeperiod; and
- Directors are prohibited from making changes to the text of the proposal.

2. Judicial Protection

When shareholder rights are violated, shareholders have the right to judicial protection. This is a fundamental right guaranteed by the Constitution of the Russian Federation.[76] In addition, the Company Law provides remedies such as the right to appeal certain company decisions, and to sue directors and managers on behalf

[75] LJSC, Article 53.

[76] The Russian Constitution, Article 46, Section 1. According to the Russian Constitution, Article 18, such rights are directly applicable.

of the company. Table 3 provides examples of these rights, which are discussed in other chapters of this Manual.

Table 3: Examples of When Shareholders Can Apply to the Court	
Shareholder Action	**Legal Basis**
Appeal the refusal to enter data into the shareholder register.	LJSC, Article 45, Section 2, Paragraph 2.
Appeal decisions of the GMS.	LJSC, Article 49, Section 7.
Appeal the refusal of the Supervisory Board to call an EGM.	LJSC, Article 55, Section 7, Paragraph 2.
Compel directors and managers to reimburse the company for losses caused to the company by their wrongful acts.	LJSC, Article 71, Section 5.

➜ *For more information on enforcement of shareholder rights, see Part V, Chapter 17.*

3. Protection by the Federal Commission for the Securities Market[77]

Securities legislation provides the Federal Commission for the Securities Market (FCSM) with the authority to:[78]

- Monitor activities of companies, brokers, stock exchanges and other professional participants of the securities market for compliance with securities legislation;
- Carry out inspections of the activities of these participants;
- Examine complaints from shareholders;
- File claims in court to protect the rights of shareholders, and to request the liquidation of entities that violate (shareholder rights) legislation; and
- File claims in courts to protect shareholder rights.

[77] In late March 2004 under government reorganization, the FCSM was replaced by the Federal Service for Financial Markets (FSFM). Its authorities are expected to be widened, with additional supervisory authority from the Antimonopoly and Finance Ministries. At the time of publishing this Manual, the authority of the new FSFM had not been finalized.

[78] Law on the Securities Market, Article 42, Clauses 10 and 19; Article 44, Clauses 6 and 7; Law on the Protection of Rights and Lawful Interests of Investors in the Securities Market, Articles 11 and 14.

The FCSM must examine complaints from shareholders within two weeks from the date a complaint is submitted.[79] Based on the results of the examination, the FCSM can issue a resolution to end the violating practice. Such a resolution can include penalties.

All individuals and legal entities in Russia must comply with the rulings of the FCSM. Its rulings can only be changed, amended, or repealed by the FCSM itself or a court decision.

4. Non-Governmental Organizations for the Protection of Shareholder Rights

Shareholders may seek assistance from associations, institutes, or other non-governmental organizations (NGOs) dedicated to the protection of shareholder rights. NGOs have the right to assist shareholders with:[80]

- Filing a claim in court to protect shareholder rights; and
- Establishing special funds for the protection of shareholders interests.

NGOs can play an important role in exerting pressure on companies, in particular those companies that act with wanton disregard of shareholder interests. NGOs may do this in a number of different ways. They may become shareholders themselves and participate in the GMS. They may also conduct letter or media campaigns to exert pressure on companies and draw public attention to the issue of shareholder rights protection. They also serve as discussion platforms, contribute to the drafting of legislation, and the education of shareholders, directors, and managers.

➜ *For a list of NGOs, see Part I, Chapter 1, Section D.4. For the role of NGOs in enforcement, see also: Part V, Chapter 17, Section F.1.*

5. Shareholder Activism and Collective Action

The protection of shareholder rights begins with good corporate behavior, an appropriate legal and regulatory framework, and appropriate enforcement procedures. Shareholders themselves must, however, also play a role in this process. Shareholders

[79] Law on the Protection of Rights and Lawful Interests of Investors in the Securities Market, Article 7.

[80] Law on the Protection of Rights and Lawful Interests of Investors in the Securities Market, Article 18.

are often the only parties who know about violations of their rights, and are in the best position to either file a complaint with the company or, ultimately, with the regulatory and judicial bodies.

Company Practices in Russia: The protection of minority shareholder rights remains a key concern for many (international) investors considering investing in Russian companies. Powerful owners/managers often pay little or no heed to minority shareholders. On the other hand, shareholders themselves are often passive, reflecting the lack of a shareholder culture among Russian investors. This comes as no surprise since citizens (often former employees of plants and factories) became shareholders practically overnight during the privatization phase, typically without having invested (material) funds before or having been educated about their rights. This makes the role of regulatory and supervisory bodies, as well as shareholder NGOs, even more important in ensuring that proper attention is paid to the protection of shareholder rights.

Another aspect of shareholder rights protection is collective action. Collective action is when a group of shareholders, who are unable to attain a right on an individual basis, combine their votes to reach a threshold to obtain the right collectively. Legislation provides for most of the above-mentioned rights to be exercised collectively. Moreover, the Company Law also provides shareholders with access to shareholder lists that helps them contact other shareholders to solicit their cooperation.

6. Shareholder Agreements

Shareholder agreements can be an important device for exercising collective action among shareholders. In fact, such agreements can enable minority shareholders to make use of minority rights (e.g. acquiring the 10% necessary to request an extraordinary inspection of business and economic affairs of the company). The situation is more complex if agreements are concluded between shareholders and the company (or one of its governing bodies). In those circumstances, shareholders may be "locked in" in a variety of ways, e.g. by obliging themselves to always vote in favor of proposals by directors or to always follow the instructions of management in matters relating to essential shareholder rights (the right to sell their shares, the right to receive dividends, and other rights).

Best Practices: Shareholder agreements can often be used to abuse shareholder rights and force (minority) shareholders to act in a certain way that is suitable for directors, managers and/or controlling shareholders. Therefore, such agreements must be carefully regulated. For example, in the U.K., shareholder agreements cannot require a shareholder to vote in one of the following ways:

- Always to follow the instructions of the company or one of its bodies;
- Always approve the proposals of the company or one of its bodies; and
- To vote in a specified manner or abstain in consideration of special advantages.

Shareholder agreements are, in principle, a form of private, civil law contract. Yet, because of their corporate governance implications, it is necessary to make certain provisions. First, shareholder agreements cannot substitute (or contradict) the founding documents of the company. It is the founding document (charter) that is mandatory, publicly regulated, and subject to disclosure (according to the state registration regime and/or securities regime). Second, it is necessary to prevent the above-mentioned forms of abuse of the ability to control the voting power of minority shareholders by prohibiting the inclusion of certain terms in such agreements. Lastly, it is necessary (particularly for publicly traded companies) to provide for greater transparency of voting control by requiring the disclosure of such arrangements.

F. Responsibilities of Shareholders

In addition to rights, shareholders also have responsibilities. The main legal responsibilities of shareholders are to:

- Pay the full value of shares that they have acquired;[81] and
- Inform the Registrar about changes in their status.[82]

Other responsibilities may exist. They may include disclosure obligations when certain thresholds of ownership are passed, or disclosure of the intent to acquire

[81] LJSC, Article 34, Clause 1.

[82] LJSC, Article 44, Clause 5.

further shares or gain control of a company. These additional responsibilities generally apply to larger shareholders, and are described throughout the Manual.

➜ *For a discussion on the disclosure of beneficial ownership, see Part IV, Chapter 13, Section B.3.*

Under certain conditions, shareholders may be held liable despite their limited liability. In particular, this refers to controlling shareholders who have the opportunity to determine the actions of or give mandatory instructions to the company.[83]

Best Practices: Finally, in some countries, shareholders, especially institutional investors, may be required to vote their shares. In other countries, there is no legal requirement but it may be considered a moral imperative. While no legal requirements for voting exist in Russia, good corporate governance depends heavily on the active participation of shareholders in the governance of the company.

[83] LJSC, Article 3, Clause 3, Paragraph 1.

Chapter 8

The **General Meeting** of **Shareholders**

Table of Contents

The Chairman's Checklist

The Authority of the General Meeting of Shareholders (GMS):

- ✓ Are the powers of the GMS clearly set forth in the charter?
- ✓ Are there any powers of the GMS that the charter explicitly delegates to the Supervisory Board?

The Preparation for the Annual General Meeting of Shareholders (AGM):

- ✓ Does the Supervisory Board provide workable and timely mechanisms to include all legitimate shareholder proposals on the agenda?
- ✓ Does the Supervisory Board have a clear duty to ensure that the agenda is not changed after it has been sent to all shareholders?
- ✓ Are all shareholders properly notified of the AGM?
- ✓ Is sufficient information available for all shareholders to take well-informed decisions on agenda items?
- ✓ Does the charter require the company to provide additional information to shareholders (or others having recognized interests) on specific agenda items?
- ✓ Does the company properly inform all shareholders of the AGM on its web-site?

Conducting the AGM:

- ✓ Is the venue of the AGM convenient and easily accessible for all company shareholders?
- ✓ Are shareholders (or their representatives) who attend the AGM properly registered and do they have the opportunity to participate in the AGM?
- ✓ Does the Supervisory Board ensure that the quorum of the AGM is properly verified and properly recorded?
- ✓ Are members of the Supervisory Board, executive bodies, and Revision Commission, as well as the External Auditor, present during the entire AGM? Do shareholders have the right and opportunity to ask questions to executives and other presenters?
- ✓ Does the Supervisory Board ensure that effective and independent vote counting mechanisms are in place during the AGM, and that the voting results are properly recorded? Does the Supervisory Board ensure that all decisions are valid and that all applicable legal requirements are met?

✓ Are the voting results and decisions properly communicated to shareholders?

The Extraordinary General Meeting of Shareholders (EGM):

✓ Does the Supervisory Board convene an EGM when circumstances require?

✓ Does the Supervisory Board convene an EGM when the Revision Commission, the External Auditor, or a shareholder (or a group of shareholders) owning at least 10% of voting shares requests an EGM?

Shareholders are the main contributors of equity capital. However, shareholders do not always wish to participate in the day-to-day management of the company's affairs. Most shareholders lack the necessary time or skills to run a company. Thus, shareholders entrust professional managers to run the company's day-to-day operations, and elect directors to supervise and guide the work of these managers. However, this does not mean that shareholders completely give up their governance rights. Shareholders most commonly exercise their governance rights through the General Meeting of Shareholders (GMS).

The GMS is the highest governing body of a company.[84] It is through the GMS that shareholders express their will with respect to such important company matters as the approval of annual reports and financial statements, the election and dismissal of directors, the payment of dividends and distribution of company profits, reorganization, major corporate transactions, and the appointment of the External Auditor. The GMS also provides shareholders with the opportunity to, at least once a year, discuss these and other important matters, meet in person with their directors and managers, ask questions, and determine the future of the company. Hence, shareholders exercise their right to participate in the decision-making of the company through the GMS.

Preparing for and conducting the GMS is subject to detailed procedural requirements as determined by law, and corporate policies and procedures. This chapter describes the authorities of the GMS, its organization, and the legal requirements for adopting valid decisions.

[84] Law on Joint Stock Companies (LJSC), Article 47, Clause 1, Paragraph 1.

A. General Provisions

1. Types of General Meetings of Shareholders

There are two types of GMS: the Annual General Meeting of Shareholders (AGM) and Extraordinary General Meeting of Shareholders (EGM).[85]

a) The Annual General Meeting of Shareholders

The Company Law requires companies to hold a GMS once every year.[86] This Meeting is called the AGM. The AGM must be held:[87]

- Not earlier than two months after the end of the fiscal year; and
- Not later than six months after the end of the fiscal year.[88]

Figure 1: The Period for Conducting an AGM

Source: IFC, March 2004

In practice, this means that a company (whose fiscal year is the same as the calendar year) must hold its AGM between March 1 and June 30 of each year. The charter must determine the period or specific date when the AGM is to be held.[89]

The AGM may not be held merely by written consent.[90] The AGM must provide shareholders the opportunity to attend (if desired, by mail-in ballots).

b) The Extraordinary General Meeting of Shareholders

All GMS other than the AGM are called the EGM.[91] They are convened in response to specific company (or shareholder) needs, such as the issuance of ad-

[85] LJSC, Article 47, Clause 1.

[86] LJSC, Article 47, Clause 1, Paragraph 2.

[87] LJSC, Article 47, Clause 1, Paragraph 3.

[88] Law on Accounting, Article 14, Clause 1 uses the term "reporting period," which is defined as a calendar year starting on January 1 and ending December 31.

[89] LJSC, Article 47, Clause 1, Paragraph 3.

[90] LJSC, Article 50, Clause 2.

[91] LJSC, Article 47, Clause 1, Paragraph 3.

ditional shares, a corporate reorganization, or for the election of directors. Under certain circumstances, the company may be required to call an EGM.

The EGM may be held:

- With the physical participation of shareholders; or
- By written consent using mail-in ballots for decision-making.

There are no limitations on the number of EGM that a company may conduct.

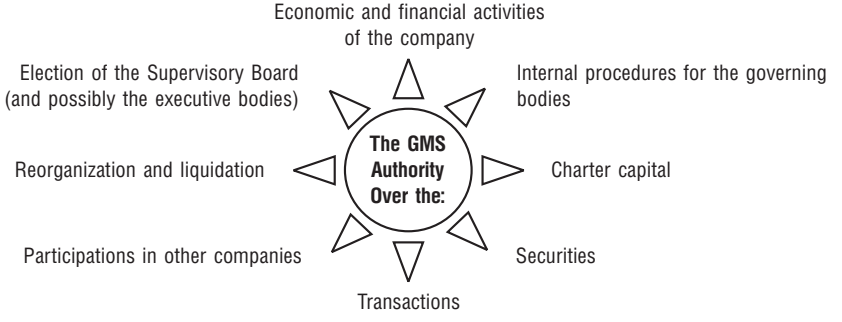
2. The Authority of the General Meeting of Shareholders

The authorities of the GMS are set forth in the Company Law[92] and are also specified in the charter.[93] The charter may not, however, provide any additional authorities that are not permitted by legislation. The GMS may delegate some of its authorities to the Supervisory Board, such as the right to elect the General Director.

➜ *For more information on the separation of authorities between the GMS and the Supervisory Board, see Part II, Chapter 4, Section A.4.a. For more information on who should elect the General Director, see Part II, Chapter 5, Section C.1.*

The authority of the GMS is summarized in Figure 2:

Figure 2: The Authority of the General Meeting of Shareholders



Source: IFC, August 2003

More specifically, the GMS has the authority related to:

[92] LJSC, Article 48, Clause 1.

[93] LJSC, Article 11, Clause 3.

a) Reorganization and Liquidation of the Company:[94]

- Reorganize the company;
- Liquidate the company and appoint members to the Creditors Committee; and
- Approve the interim and final liquidation balance sheets.

➜ *For more information on reorganizations, see Part V, Chapter 16.*

b) Election of the Governing Bodies:[95]

- Determine the number of directors, as well as to elect and dismiss them;
- Approve the remuneration of directors;
- Appoint and dismiss the General Director and Executive Board members (unless the charter delegates this authority to the Supervisory Board); and
- Transfer the authority of the General Director to the External Manager.

c) Control over the Company:[96]

- Approve the by-laws for the Revision Commission;
- Elect and dismiss Revision Commission members;
- Approve the remuneration of the Revision Commission members;
- Request an extraordinary inspection by the Revision Commission;
- Appoint the External Auditor;
- Approve annual reports and annual financial statements; and
- Declare and pay dividends.

➜ *For more information on internal and external control structures, see Part III, Chapter 14.*

d) Procedures for Governing Bodies:[97]

- Amend the charter or approve a new version of the charter;
- Establish the procedures for conducting the GMS;
- Elect and dismiss Counting Commission members and set the number of its members; and

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[94] LJSC, Article 48, Clause 1, Sections 2 and 3.

[95] LJSC, Article 48, Clause 1, Sections 4 and 8; Article 64, Clause 2; Article 69, Clause 1, Paragraph 3.

[96] LJSC, Article 48, Clause 1, Sections 9, 10, 10.1, and 11; Article 85, Clause 1, Paragraph 2; Clause 2, Paragraph 2, and Clause 3.

[97] LJSC, Article 48, Clause 1, Sections 1, 12, 13 and 19; Article 56, Clause 1.

- Approve the by-laws for the governing bodies of the company (the GMS, the Supervisory Board, the General Director, and the Executive Board).

e) Charter Capital:[98]

- Increase the charter capital by increasing the nominal value of issued shares;
- Determine the number, nominal value, types, and classes of authorized shares that may be issued and placed by the company;
- Increase the charter capital by issuing additional shares (unless the charter delegates this authority to the Supervisory Board);
- Reduce the charter capital by decreasing the nominal value of issued shares; and
- Reduce the charter capital by reducing the number of issued shares by retiring treasury shares.

➜ *For more information on the charter capital, see Chapter 9.*

f) Securities:[99]

- Split and consolidate shares;
- Approve the buy-back of company shares in cases specified by the Company Law;
- Issue bonds and other convertible securities, unless the charter delegates this authority to the Supervisory Board; and
- Issue shares and other convertible securities through closed subscription.

➜ *For more information on securities, see Chapter 11.*

g) Transactions:[100]

- Approve extraordinary transactions;
- Approve related party transactions; and
- Waive the obligation of the controlling shareholder(s) to make a buy-out offer during control transactions.

➜ *For more information on control transactions, see Chapter 12, Section B.*

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[98] LJSC, Article 48, Clause 1, Sections 5–7.

[99] LJSC, Article 48, Clause 1, Sections 14 and 17; Article 33, Clause 2, Paragraph 2; Article 39, Clause 3.

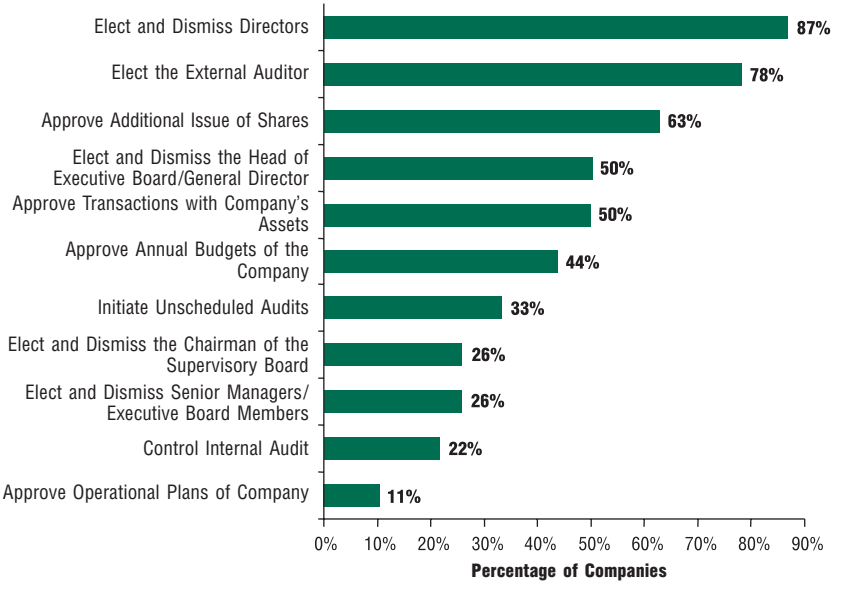
[100] LJSC, Article 48, Clause 1, Sections 15 and 16; Article 80, Clause 2, Paragraph 2.

h) Participation in Other Companies:[101]

- Authorize the company to participate in holding companies, financial and industrial groups, associations or other groups of commercial enterprises.

Company Practices in Russia: As depicted in Figure 3, most GMS appear to perform the functions assigned to them by law. The most common are electing and dismissing directors (87%), electing the External Auditors (78%), and approving additional issues of company shares (63%).[102] More revealing than the functions performed by the GMS are the responsibilities that it is supposed to fulfill but does not. For example, in 19% of the surveyed companies, the GMS does not approve an independent External Auditor.

Figure 3: Powers of the GMS



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

[101] LJSC, Article 48, Clause 1, Section 18.

[102] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.3.1, page 33, August 2003 (see www.ifc.org/rcgp).

3. Delegation of Authority

The authorities of the GMS may not be delegated to the executive bodies. However, the charter may delegate the following tasks to the Supervisory Board:[103]

- Appointing and dismissing the General Director and Executive Board members;
- Increasing the charter capital by issuing additional shares; and
- Issuing bonds (and other convertible securities).

B. Preparing for the Annual General Meeting of Shareholders

Preparing for the AGM requires careful planning and adherence to procedural requirements. The procedures are set out in the Company Law[104] and regulations issued by the Federal Commission for the Securities Market (FCSM).[105] Additionally, The FCSM's Code of Corporate Conduct (FCSM Code) provides useful recommendations.

The steps that must be followed are summarized in Figure 4.

1. Drafting the Agenda

The first step in preparing for the AGM is to draft an agenda. The agenda structures the AGM, and lists issues that must be addressed.[106]

a) Who May Submit Agenda Items

A shareholder (or a group of shareholders) holding at least 2% of voting shares may propose agenda items, including the nomination of candidates to the governing bodies.

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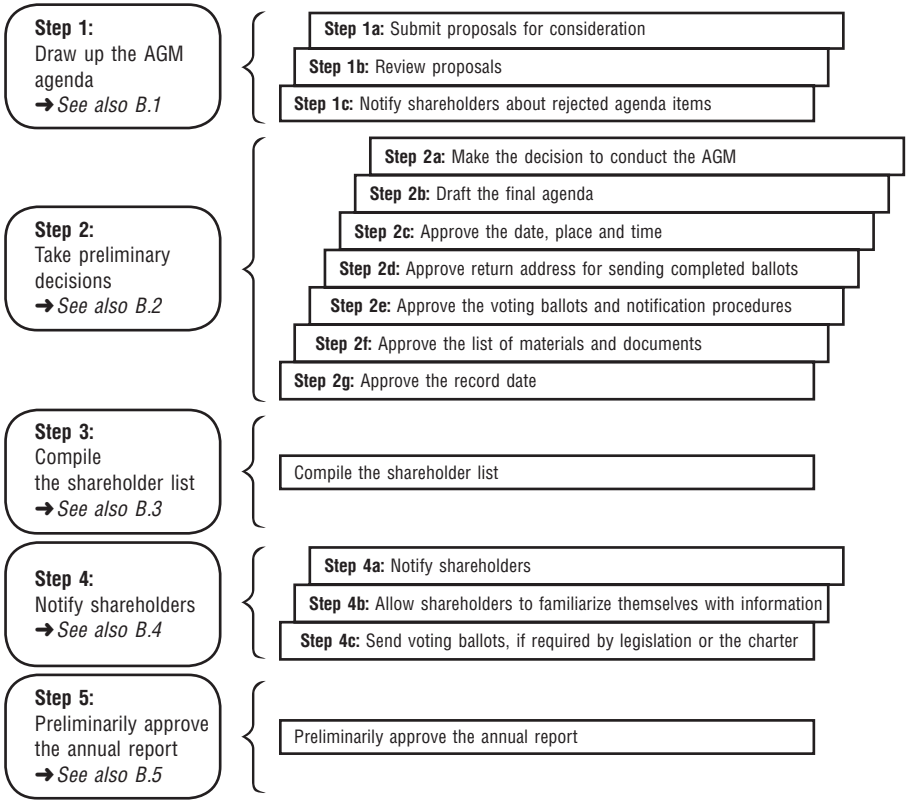
[103] LJSC, Article 48, Clause 2, Paragraphs 1 and 2.

[104] LJSC, Articles 51 to 54.

[105] LJSC, Article 47, Clause 2. See also: FCSM Regulation No. 17/ps on Additional Requirements to the Procedure of Preparing, Calling and Conducting the General Meeting of Shareholders (FCSM Regulation No. 17/ps), 31 May 2002.

[106] Federal Commission for the Security Market's Code of Corporate Conduct (FCSM Code), Chapter 2, Section 1.4.1.

Figure 4: Preparation for the AGM



Source: IFC, March 2004

The signatory of the proposal is considered the individual who submits the proposal.[107] The date on which a shareholder's ownership should be verified is the date of legal submission.[108]

[107] FCSM Regulation No. 17/ps, Section 2.2.

[108] FCSM Regulation No. 17/ps, Section 2.3.

b) How and When to Submit Agenda Proposals

Shareholders must submit proposals in writing:[109]

- By regular mail to the General Director (or the External Manager). The postal address must be included in the State Register of Legal Entities, the charter, or the relevant by-laws. Proposals are considered submitted as of the postmark date; or
- By hand to the General Director (or to the Chairman of the Supervisory Board, the Corporate Secretary, or any other person entitled to receive mail on behalf of the company). The delivery must be verified by dated receipt. The date of receipt of such a proposal is deemed to be the date of submission; or
- By other means, such as e-mail or fax (if allowed by the charter and/or by-laws). In this case, the charter or by-laws determine the date of submission.

The company must receive proposals no later than 30 days after the end of fiscal year, unless the charter allows for a later submission.[110]

c) Required Proposal Information

A shareholder (or a group of shareholders) owning 2% or more of voting shares may propose any number of issues for the agenda. Each proposal must contain:[111]

- The name of the submitting shareholder(s);
- The number, types, and classes of shares held by the shareholder(s);
- The text of the proposal (it may also contain proposed wording for shareholders to vote on); and
- The signature(s) of the submitting shareholder(s).

If a shareholder representative signs the proposal, a valid power of attorney must be attached.[112]

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[109] LJSC, Article 53, Clause 3. FCSM Regulation No. 17/ps, Sections 2.1 and 2.4.

[110] LJSC, Article 53, Clause 1.

[111] LJSC, Article 53, Clauses 3–4.

[112] FCSM Regulation No. 17/ps, Section 2.7.

Best Practices: Shareholder proposals should be included as separate items on the agenda. However, certain agenda items should be grouped together. For example, a decision on reorganization through spin-off may only be approved if the AGM also approves the following related issues:

- The spin-off procedure;
- Terms and conditions of the spin-off;
- The establishment of new companies as a result of reorganization;
- The procedure to convert the reorganized company's shares into shares of new companies; and
- The approval of a transfer balance sheet.

d) Information to Be Included in Candidate Proposals

A shareholder (or a group of shareholders) owning at least 2% or more of voting shares may propose candidates for the:

- Supervisory Board;
- General Director and Executive Board;[113]
- Counting Commission; and
- Revision Commission.

The number of candidates that may be proposed is limited to the size of the body specified in the charter or by-laws.[114]

Candidate proposals must contain the:[115]

- Name of candidates;
- Name of the body for which candidates are nominated;
- Name(s) of the shareholder(s) submitting the proposal;
- Number, types, and classes of shares held by the submitting shareholder(s); and
- Signature(s) of the shareholder(s).

[113] LJSC, Article 53, Clause 1. Note that shareholders have the right to propose candidates for the position of General Director and Executive Board members only if the establishment of the company's executive bodies falls within the authority of the GMS. The charter must specifically address this.

[114] LJSC, Article 53, Clause 1.

[115] LJSC, Article 53, Clause 4; FCSM Regulation No. 17/ps, Section 2.8.

The charter, by-laws, or other internal documents of the company may require additional information.

As under item B.1.c above, if a shareholder representative signs the proposal, a valid power of attorney must be attached.[116]

Best Practices: Candidates should be informed of their nomination. In addition, the AGM documents should contain an agreement that, if elected, candidates will accept the position.[117] In the absence of such an agreement, it is recommended that the candidate physically attend the AGM and verbally confirm his acceptance if elected, before shareholders vote on his candidacy.

e) Proposal Review by the Supervisory Board

The Supervisory Board must decide whether to accept or reject shareholder proposals within five days after the submission deadline. It may reject a proposal only when:[118]

- The proposal is not submitted within the period determined by law and the charter;
- A submitting shareholder (or a group of shareholders) does not possess at least 2% of voting shares;
- The proposal is incomplete or does not meet the legal requirements for proposals;
- The AGM does not have the authority to decide on the proposed item; or
- The proposal does not otherwise comply with legislation (for example, if the shareholder proposes to declare dividends when this recommendation may only be made by the Supervisory Board).

[116] FCSM Regulation No. 17/ps, Section 2.7.

[117] FCSM Regulation No. 17/ps, Section 2.8; FCSM Code, Chapter 2, Section 1.3.6.

[118] LJSC, Article 53, Clause 5.

The Supervisory Board may not invoke any other grounds for rejecting proposals.

Best Practices: Companies should check the shareholder register to verify shareholders' right to participate in the AGM, rather than require shareholders to submit supporting documents.[119]

f) The Notification of Shareholders of Rejected Proposals

The Supervisory Board must notify shareholders within three days of making the decision if their proposals are rejected.[120] It must provide them with the text of its decision stating the reasons for the rejection. Legislation does not specify how shareholders should be notified when proposals are rejected. It is, however, recommended that they be notified by registered mail.

The rejection of or failure to make a decision on shareholder proposals may be appealed to a court.[121]

The Company Law does not require shareholders to be notified if their proposals are accepted.[122] It is assumed that they will receive sufficient notification when they receive the agenda.

2. Making Key Decisions

As depicted on Figure 5, the Supervisory Board must make a number of key decisions in preparing for the AGM.[123]

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[119] FCSM Code, Chapter 2, Section 1.5.

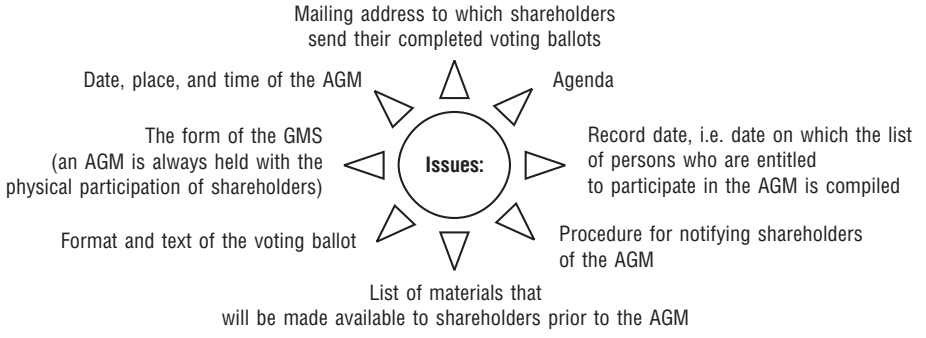
[120] LJSC, Article 53, Clause 6.

[121] LJSC, Article 53, Clause 6.

[122] LJSC, Article 53, Clause 6.

[123] LJSC, Article 54, Clause 1. LJSC, Article 60, Clause 2, Paragraph 2. The distribution of voting ballots prior to the AGM is mandatory for companies with 1,000 or more shareholders with voting rights; for companies with fewer than 1,000 shareholders with voting rights, only if required by the charter. (➜ *For more information on voting ballots, see Section B.4 of this Chapter.*) LJSC, Article 60, Clause 1, Paragraph 2. Voting during the AGM must be done by ballot if the company has more than 100 shareholders with voting rights.

Figure 5: Issues that the Supervisory Board Must Decide



Source: IFC, March 2004

In addition to the requirements of the Company Law, the FCSM requires that the Supervisory Board decide on:[124]

- Which classes of preferred shares grant voting rights to their owners on each agenda item; and
- When the registration of participants at the AGM shall start.

a) The Decision to Conduct the AGM

The Supervisory Board must decide to conduct the AGM before its preparation may start. As part of this decision, the Supervisory Board decides as to the final agenda; date, place, and time; address to which completed ballots must be sent; notification procedure and text of the voting ballot; list of materials; and record date.

b) The Date of the AGM

The company must conduct its AGM on a date that is determined by the charter.

Company Practices in Russia: In practice, the charter typically provides for a period of time within which the AGM must be held. The Supervisory Board then determines the exact date for each AGM, within the period stipulated by the charter.

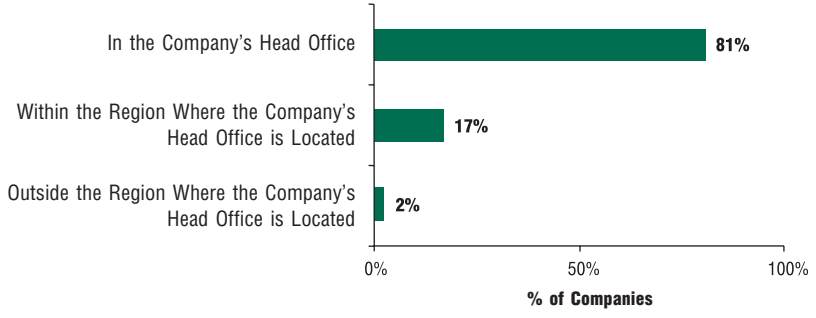
[124] FCSM Regulation No. 17/ps, Section 2.10.

c) The Place of the AGM

The company is required to conduct the AGM where it has its registered seat unless otherwise specified by the charter or by-laws.[125]

Company Practices in Russia: Today most companies in Russia hold their GMS in easily accessible locations. This is in stark contrast to practices in the 1990s. Figure 6 shows that 81% of the companies in Russia's regions used their head office to host the GMS.[126] A further 17% held their GMS within the region where their head office was located, and only 2% of these companies held their GMS outside of the region in which they were located.

Figure 6: Common GMS Locations



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

Current company practices are consistent with the FCSM Code's recommendations that:[127]

- The AGM should be held at a location and at a time that facilitates shareholders to participate and does not impose undue expenses upon them;
- The AGM should be held where the company is located or at a location defined by the charter;
- Companies that are located where access is difficult should choose a venue that is easy to access (for example, by public transport). This location should be specified in the charter;

[125] FCSM Regulation No. 17/ps, Section 2.9.

[126] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.3.1, page 32, August 2003 (see www.ifc.org/rcgp).

[127] FCSM Code, Chapter 2, Section 1.2. and 1.6.

- The premises should be able to accommodate all shareholders who want to participate; and
- Companies should estimate how many participants are likely to attend the AGM and plan accordingly.

d) Approving the Agenda

The Supervisory Board must approve the final AGM agenda. The agenda is composed of items that are:

- Proposed by shareholders; and
- Included upon the Supervisory Board's initiative.

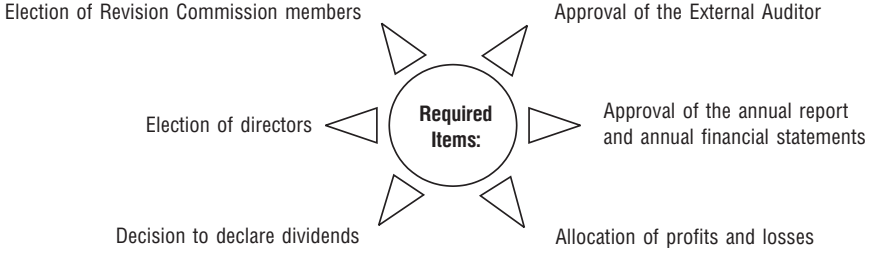
The Supervisory Board must include all shareholder proposals on the agenda that were not rejected. The Supervisory Board may not change the wording of any proposal, or the wording of the proposed decision to be taken on that item.[128] Once the Supervisory Board has approved the final agenda, it may not be changed.

The Supervisory Board may include:[129]

- Items in addition to those required by the Company Law or those proposed by shareholders; and
- Additional candidates for governing bodies if shareholders failed to propose a sufficient number. It is good practice for the Supervisory Board to include a sufficient number of candidates to fill all positions for governing bodies.

Figure 7 shows the items that the agenda must include.[130]

Figure 7: Required AGM Agenda Items



Source: IFC, March 2004

[128] LJSC, Article 53, Clause 7, Paragraph 1.
[129] LJSC, Article 53, Clause 7, Paragraph 2.
[130] LJSC, Article 54, Clause 2.

e) The Record Date

The record date, sometimes referred to as the fixing date, is the date used to determine who is entitled to participate in the AGM. The record date must be set by the Supervisory Board prior to the AGM, and may not be set at a date that is:[131]

- Earlier than the Supervisory Board's decision to conduct the AGM;
- More than 50 days prior to the AGM; and
- Less than 45 days prior to the AGM, if voting ballots must be sent.

3. Preparing the Shareholder List

The next step in preparing for the AGM is to compile the list of shareholders who are entitled to participate in the AGM. The shareholder list is based on information from the Registrar on the record date.[132]

Once the Supervisory Board has set the record date, the General Director must tell the Registrar to compile the shareholder list.[133] The shareholder list is prepared for the Supervisory Board to:

- Determine which shareholders are entitled to participate in the AGM;
- Notify shareholders of the AGM;
- Determine which shareholders have the right to receive dividends; and
- Give shareholders the opportunity to verify that their rights are registered properly.

a) Who Should Be Included on the Shareholder List

Only persons included on the shareholder list are entitled to participate in the AGM. Figure 8 depicts who should be included on the shareholder list:[134]

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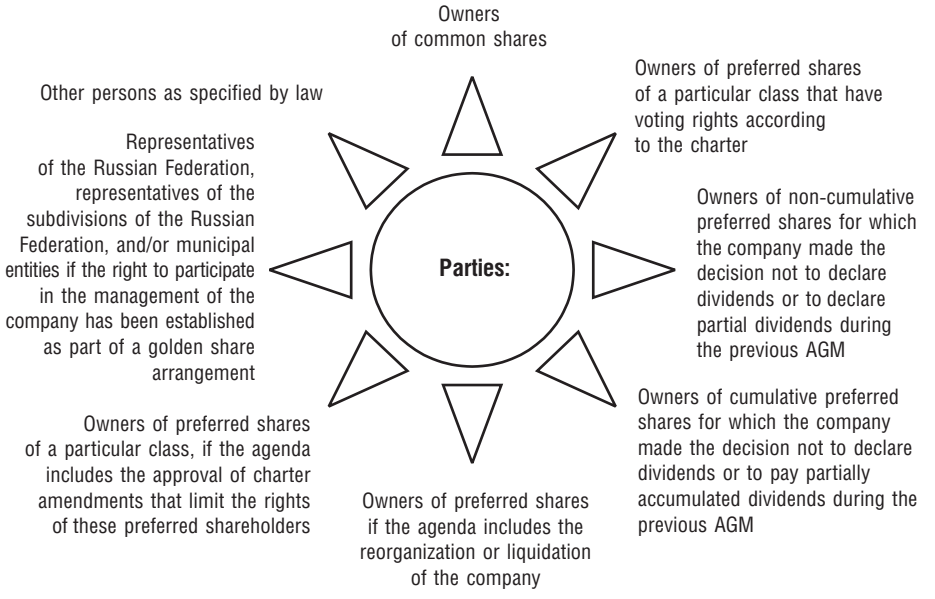
[131] LJSC, Article 51, Clause 1.

[132] LJSC, Article 51, Clause 1, Paragraph 1.

[133] The holder of the shareholder register will typically be the company or an External Registrar. See also: Chapter 7, Section D.

[134] FCSM Regulation No. 17/ps, Section 2.11. All shares of the company must be fully paid. LJSC, Article 34, Clause 1, Paragraph 3 specifies that shares that are held by the founders of the company, but are not fully paid do not grant voting rights to their owners, unless the charter provides otherwise. Because of amendments to the LJSC, preferred shares with voting rights cannot be placed after January 1, 2002. Securities convertible into preferred shares

Figure 8: Who Should Be Included on the Shareholder List



Source: IFC, March 2004

b) Nominal Shareholders and the Shareholder List

To ensure that all shareholders are included in the shareholder list, nominal shareholders (such as brokers, banks, and investment funds that manage shares on behalf of shareholders) are required to provide the company with information on the ultimate or beneficial owners they represent.[135]

➜ *See also Part IV, Chapter 13, Section B.3 for more information on the disclosure of beneficial ownership.*

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with voting rights can not be converted into voting preferred shares after January 1, 2002. The amendments to the LJSC have eliminated the possibility of issuing preferred shares that have voting rights if this is specified by the charter. FCSM Regulation No. 17/ps does not specify these other persons.

[135] LJSC, Article 51, Clause 2.

c) Information in the Shareholder List

The shareholder list must contain information on each individual and legal entity including:[136]

- Name;
- Identification details;
- The number, type, and class of shares held; and
- A mailing address in the Russian Federation.

d) Disclosure of Information in the Shareholder List

Two information disclosure situations may be differentiated:[137]

- Disclosure to larger shareholders; and
- Verification by a shareholder of his own holdings.

In the first situation, the shareholder list should be made available to all shareholders who own at least 1% of voting shares. Information regarding physical persons, including their mailing address, may however only be disclosed with their permission.[138]

In the second situation, shareholders are entitled to verify the accuracy of the information in the register about themselves and their holdings. If the shareholder is unable to verify his inclusion on the shareholder list, the company must issue a statement within three days of the request.

The Supervisory Board may amend the shareholder list after the record date only to restore the rights of persons who were omitted or to correct other errors.[139]

e) Shareholder Obligations When Selling Shares After the Record Date But Prior to the Annual General Meeting of Shareholders

Shareholders lose voting rights when they sell their shares, as voting rights are transferred automatically to the new owner. However, as the shareholder list is not updated after the record date, the selling shareholder must ensure that the new shareholder may vote at the AGM. There are two ways for the selling shareholder to fulfill his obligation:[140]

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[136] LJSC, Article 51, Clause 3.

[137] LJSC, Article 51, Clause 4.

[138] LJSC, Article 51, Clause 4.

[139] LJSC, Article 51, Clause 5.

[140] LJSC, Article 57, Clause 2.

- Grant a power of attorney to the new owner; or
- Participate in the AGM and vote in accordance with the instructions of the new owner.

In practice, these two options only work when the shareholder knows:

- **The identity of the buyer:** In Russia, as elsewhere in the world, shares are generally sold anonymously through intermediaries thus making it impossible for the seller to identify and contact the buyer. It gets more complicated when shares are sold to multiple shareholders or during multiple and sequential transactions.
- **The record date:** In practice, shareholders are not notified about the record date before they are notified of the AGM. This makes it difficult for the seller to know if he is obliged to act in order to allow the new shareholder to participate in the AGM.

Securities legislation further regulates this issue. In particular, if a shareholder sells his shares after the record date to multiple shareholders, then he is required to either: 1) vote based on the instructions of the new owners; and/or 2) give a power of attorney to all new owners specifying the number of shares the new owner may vote in accordance with the following:[141]

- If the instructions of the new owners coincide, their votes must be combined;
- If the instructions of new owners do not coincide, the seller must vote in accordance with the instructions of new owners;
- If the new owners receive power of attorney from the seller, the new shareholders must be registered in order to participate in the AGM, and they must be given new voting ballots;
- If voting shares are being circulated in foreign markets in the form of depositary receipts, voting must be based on the instructions of the depositary receipt holders.

➜ *For more information on depositary receipts, see Chapter 11, Section G.*

[141] FCSM Regulation No. 17/ps, Section 2.12.

4. Providing Proper Notice

Once the procedures set out in Section B.3 are completed, all shareholders of record must be notified of the AGM:[142]

- No later than 20 days prior to the AGM; or
- No later than 30 days prior to the AGM if the agenda includes the reorganization of the company.

Best Practices: It is good practice that notification of the AGM:[143]

- Allows sufficient time for all shareholders to prepare for the AGM;
- Is given to all shareholders;
- Allows sufficient time for shareholders to contact other shareholders; and
- Occurs at least 30 days in advance.

a) How to Notify

Shareholders must be notified of the AGM by:[144]

- Registered mail, unless the charter provides otherwise; or
- Hand delivery with a delivery receipt; or
- Publication in a newspaper or other printed media with a large circulation, if provided by the charter.

Company Practices in Russia: An IFC survey of corporate governance practices in Russia's regions shows that most companies send announcements by registered mail and/or publish them in the print media, as shown in Figure 9 below.[145]

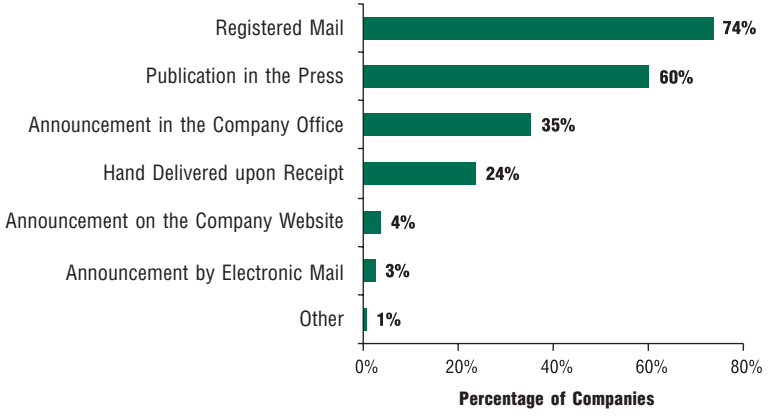
[142] LJSC, Article 52, Clause 1.

[143] FCSM Code, Chapter 2, Section 1.1.1.

[144] LJSC, Article 52, Clause 1, Paragraph 3.

[145] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.3.1, page 31, August 2003 (see www.ifc.org/rcgp).

Figure 9: Method of AGM Notification



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

The company may also notify shareholders of an AGM by television or radio, or other methods such as the internet.[146] These other methods may not, however, replace those required by the Company Law and those specified in the charter.

Best Practices: Every reasonable effort should be made to inform shareholders of an upcoming AGM.[147] A broader reach may be achieved by:

- Permitting the use of e-mail and the internet;
- Using widely read print media to disseminate notice; and
- Using no less that two and, ideally, several publications to give notice.

b) Information that Is Included in the AGM Notification

The AGM notification must include information required by the Company Law and the FCSM.[148] In addition, the FCSM Code states that notification should

[146] LJSC, Article 52, Clause 1, Paragraph 4.

[147] FCSM Code, Chapter 2, Sections 1.1.3 and 1.1.4.

[148] LJSC, Article 52, Clause 2; FCSM Regulation No. 17/ps, Section 3.1; FCSM Code, Chapter 2, Section 1.1.2.

contain sufficient information to enable shareholders to decide whether they will participate and how they will participate. Legal requirements and the FCSM Code's recommendations are summarized in Table 1.

Table 1: Information to Include in the AGM Notification

Information	Required	Recommended
Full name and location of the company	✓	✓
Date, place, and time of the AGM	✓	✓
Mailing address for sending voting ballots (if applicable)	✓	✓
Record date of the AGM	✓	✓
Agenda	✓	✓
Procedures for receiving background materials	✓	✓
The time when the registration of participants starts	✓	✓
The place where registration takes place		✓
The person to whom shareholders may report violations of the registration procedure		✓

c) Information and Materials for the AGM

The Company Law and securities legislation list the background materials that must be made available to shareholders before the AGM.[149]

Best Practices: Companies should identify additional materials that may need to be provided to shareholders in their charter.[150]

Legal requirements and the FCSM Code's recommendations are summarized in Table 2.

[149] LJSC, Article 52, Clause 3, Paragraph 1; FCSM Regulation No. 17/ps, Sections 3.2 to 3.5;

[150] FCSM Code, Chapter 2, Section 1.3.1.

Table 2: AGM Materials		
Information (Materials)	**Required**	**Recommended**
Annual report and annual financial statements	✓	✓
Report of the Revision Commission	✓	✓
Report of the External Auditor	✓	✓
Recommendations of the Supervisory Board regarding the distribution of profits, including the amount of dividends and the procedure for the payment of dividends, and regarding the distribution of losses	✓	✓
Draft charter amendments, draft of the new version of the charter, if any	✓	✓
Draft by-laws, if any	✓	✓
Drafts of decisions of the AGM	✓	✓
Information on proposed candidates for the position of General Director, and for members of the Executive Board, Supervisory Board, Revision Commission, and Counting Commission	✓	✓
Consent of nominees to accept the position if they are elected	✓	✓
Materials that must be made available when the agenda includes items that may trigger redemption rights: • The report of an Independent Appraiser on the market value of the company shares; • The net assets of the company based on the financial statements for the last reporting period; and • The minutes of the Supervisory Board meeting, which determined the redemption price for shares, including the redemption price.	✓	✓
Materials that must be made available when the agenda includes the reorganization of the company: • The justification of the terms and procedures of the reorganization, contained in the decision on the division, separation, or transformation, or in the contract on merger or accession approved by the Supervisory Board; • The annual reports and financial statements of all companies involved in the reorganization for the last three fiscal years or for all completed fiscal years if the company was established less than three years ago; and • The quarterly accounting documents for the quarter that precedes the date of the AGM.	✓	✓

Table 2: AGM Materials		
Information (Materials)	**Required**	**Recommended**
The position of the Supervisory Board on each agenda item and any dissenting opinions.[151]		✓

d) When and Where Materials Must Be Made Available

AGM materials must be made available at the premises of the company where the General Director is located and any other places specified in the AGM notification:[152]

- 20 days prior to the AGM; or
- 30 days prior to the AGM, if the agenda includes the reorganization of the company.

Information may also be made available at other places, preferably in an area where a significant numbers of shareholders reside,[153] as long as the address is specified in the AGM notification.

Best Practices: AGM materials should be posted on the internet, preferably on the company's website. Electronic dissemination is a simple and cost-effective method of allowing broad public access.

Each shareholder of record has the right to receive copies of AGM materials. The company may recoup the actual cost of making copies from shareholders.[154] Copies must be provided within five days of the request, unless the charter or by-laws specify a shorter period.[155]

e) When and How Voting Ballots Are Sent to Shareholders

The Company Law dictates when the company is required to use voting ballots and when to distribute these in advance.

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[151] FCSM Code, Chapter 2, Section 1.3.3.

[152] LJSC, Article 52, Clause 3, Paragraph 3.

[153] FCSM Code, Chapter 2, Section 1.3.5.

[154] LJSC, Article 52, Clause 3, Paragraph 4.

[155] FCSM Regulation No. 17/ps, Section 3.8.

Companies with more than 100 shareholders with voting rights must always use voting ballots.[156] Companies with fewer shareholders may use voting ballots if required by the charter.

The company is required to distribute voting ballots if it has more than 1,000 shareholders with voting rights or the charter requires so.[157]

Voting ballots must be distributed to all shareholders of record:[158]

- No later than 20 days prior to the AGM; and
- By registered mail, if the charter does not provide otherwise; or
- By hand with a delivery receipt.

For companies with more than 500,000 shareholders with voting rights, the charter may allow for the publication of voting ballots in the print media.[159]

f) Information on Voting Ballots

Voting ballots must include the information summarized in Table 3.[160]

Table 3: Information That Must Be Included on the Voting Ballot

Required Information	The Company Law	The FCSM Code
The full name and location of the company	✓	✓
The form of the AGM (either in the presence of shareholders or by written consent)	✓	✓
The date, place, and time of the AGM	✓	✓
Deadline prior to which completed ballots must be sent to the company	✓	✓
The mailing address to which completed ballots must be sent	✓	✓

[156] LJSC, Article 60, Clause 1.

[157] LJSC, Article 60, Clause 2, Paragraph 2.

[158] LJSC, Article 60, Clause 2, Paragraphs 2 and 3.

[159] LJSC, Article 60, Clause 2, Paragraph 4.

[160] LJSC, Article 60, Clause 4. FCSM Letter on Information that is Contained in the Voting Ballot for the General Meeting of Shareholders, 16 June 2000, Section 4; FCSM Regulation No. 17/ps, Sections 2.13. and 2.14.

Table 3: Information That Must Be Included on the Voting Ballot		
Required Information	**The Company Law**	**The FCSM Code**
The wording of decisions on each issue and the names of candidates	✓	✓
The instruction that the ballot must be signed by the shareholder	✓	✓
The exact wording "for," "against," or "abstain" alongside each decision	✓	✓
An explanation of cumulative voting with the following text: "When Supervisory Board members are elected with cumulative voting, the shareholder may cast all his votes for one candidate or for several candidates"		✓
The ballot must have a designated area where shareholders must insert the number of votes they cast for each candidate		✓
The ballot must contain an explanation that fractions of a vote may only be cast for one candidate		✓
The ballot must show the number of votes each shareholder may cast to decide on each decision based on information from the shareholder list		✓
Instructions on how to complete the ballot ➜ *See also Section C.11 in this Chapter*.		✓
The instruction that a shareholder who is a physical person must write his last name when he signs the ballot		✓
The instruction that an individual who completes the ballot on behalf of a shareholder that is a legal entity must indicate his name and position, and the full name of the legal entity which he represents		✓
The instruction that a copy of the power of attorney must be attached to the ballot, and that the representative of the shareholder must sign the voting ballot (if the voting is by proxy)		✓

g) Nominal Shareholders and Shareholder Notification

The AGM notification must be sent to nominal shareholders if the mailing address of the beneficial owner is unknown.

If notice is sent to a nominal shareholder, the nominal shareholder must inform the beneficial owner of the AGM. The nominal shareholder must give notice in

accordance with the procedure and time specified by legislation, or by agreement with the beneficial owner.[161]

5. Preliminarily Approving the Annual Report

The last step in preparing for the AGM is for the Supervisory Board to preliminarily approve the annual report, which must occur no later than 30 days prior to the AGM.[162] Before it does so, the Revision Commission must verify the annual report.[163] The AGM then approves the final version of the annual report.

C. Conducting the Annual General Meeting of Shareholders

The company may conduct the AGM once all the preparatory steps have been completed. The AGM is a key corporate governance event, and its proper implementation thus takes on added importance.

Best Practices: The AGM should be used to inform shareholders about company activities, achievements, and plans, and to involve shareholders in important decisions. For a minority shareholder, the AGM is often the only chance to obtain detailed information about the company's operations, and to meet management and directors.[164]

Convening and conducting the AGM is a complex task and a number of steps must be followed to ensure that the AGM meets legal requirements and the FCSM Code's recommendations.

Best Practices: The AGM should not start prior to 09.00 and should end not later than 22.00.[165] Clearly, one should steer away from a marathon AGM in order to avoid exhausting participants. This may pose considerable organizational challenges when the issues to be decided are either complex, contentious, and/or numerous.

[161] LJSC, Article 52, Clause 4.

[162] LJSC, Article 88, Clause 4.

[163] LJSC, Article 88, Clause 3, Paragraph 1.

[164] FCSM Code, Introduction to Chapter 2.

[165] FCSM Code, Chapter 2, Section 1.6.3.

The overriding principle for organizing the AGM is that it should be conducted in such a manner so as to facilitate effective shareholder participation and decision-making.

An overview of the steps necessary to organize the AGM is provided in Figure 10.

1. Shareholder Participation Options

Shareholders may attend the AGM in person or grant a power of attorney to a representative (proxy) who attends the AGM on the shareholder's behalf.[166] Shareholders may also participate in the GMS by sending completed voting ballots to the company (if voting ballots are distributed in advance). If participation is by proxy, the power of attorney must be drafted in compliance with legislation or notarized to become valid.[167] It may be revoked and/or transferred to another person at any time by the shareholder. In addition, the shareholder may change the terms of the proxy and give his representative different instructions at any time.

➜ *See Part VI, Annexes 22 and 23 for a model proxy from an individual and a legal entity, respectively.*

In case of joint ownership of shares, proxy voting may be by:[168]

- One of the owners, acting on behalf of all owners on the basis of a valid proxy; or
- A joint representative, acting on the basis of a valid proxy.

If an individual shareholder dies or a legal entity shareholder reorganizes after the record date, the legal heir or the new shareholder may attend.[169]

[166] LJSC, Article 57, Clause 1, Paragraph 1.

[167] LJSC, Article 57, Clause 1, Paragraph 3.

[168] LJSC, Article 57, Clause 3.

[169] FCSM Regulation No. 17/ps, Section 4.1.

Figure 10: Steps for Conducting the AGM

Step 1:
The Counting Commission registers persons attending the AGM. **C.2**

Step 2:
The Counting Commission verifies and announces the quorum. **C.3**

Step 3:
The Chairman of the Supervisory Board opens the AGM, unless the charter provides otherwise. **C.4**

Step 4:
Shareholders elect a new Counting Commission if its term has expired. **C.5**

Step 5:
Shareholders elect the AGM Chairman, if the charter does not define who is to preside. **C.6**

Step 6:
Shareholders elect the AGM Secretary, if the charter does not define the Secretary. **C.7**

Step 7:
Shareholders decide on the presence of outside guests (other than those allowed by the charter). **C.8**

Step 8:
The AGM Chairman presents the agenda and the rules of order. **C.9**

Step 9:
The AGM Chairman opens the discussion on agenda items. **C.10**

Step 10:
Shareholders vote on agenda items. **C.11**

OPTION 1: ANNOUNCING VOTING RESULTS DURING THE AGM	OPTION 2: ANNOUNCING VOTING RESULTS AFTER THE AGM
Step 11.1: The Counting Commission counts votes and prepares the minutes on the voting results. **C.12**	**Step 11.2:** The AGM Chairman closes the AGM. **C.14**
Step 12.1: The AGM Chairman announces voting results and decisions. **C.13**	**Step 12.2:** The Counting Commission counts votes and prepares the minutes on the voting results. **C.12**
Step 13.1: The AGM Chairman closes the AGM. **C.14**	**Step 13.2:** The Counting Commission archives voting ballots. **C.15**
Step 14.1: The Counting Commission archives voting ballots. **C.15**	**Step 14.2:** Shareholders are notified of the official voting results and AGM decisions. **C.17**

Step 15:
The AGM Secretary prepares and archives the AGM minutes. **C.16**

Source: IFC, March 2004

2. Shareholder Registration

The previous year's Counting Commission registers shareholders or shareholder representatives before the AGM may begin.[170] Participants must be registered to verify the quorum. In the absence of a quorum, the AGM must be rescheduled. It should be noted that shareholders whose voting ballots were received at least two days prior to the AGM are automatically registered.[171]

Best Practices: To avoid company officials preventing shareholders from participating in the AGM, e.g. by blocking registration, the registration procedure should be described in detail in the internal documents of the company, and in the GMS notification.[172]

a) Who Registers Shareholders

Registration of participants must be done by:

- The body specified by the charter when the company has 100 or fewer shareholders with voting rights, or by the External Registrar;[173] or
- The Counting Commission[174] when the company has more than 100 shareholders with voting rights;[175] or
- The External Registrar if it is assigned to perform such functions;[176] or
- The External Registrar when the company has more than 500 shareholders with voting rights.

b) Who Must Be Registered

The following persons must be registered before they may participate in the AGM:[177]

[170] LJSC, Article 56, Clause 4.

[171] FCSM Regulation No. 17/ps, Section 4.6.

[172] FCSM Code, Chapter 2, Section 2.2.1.

[173] FCSM Regulation No. 17/ps, Section 4.4.

[174] Hereinafter, any references to the Counting Commission include other bodies fulfilling the function of the Counting Commission, as specified by the Company Law and/or the charter.

[175] LJSC, Article 56, Clause 1, Paragraph 1.

[176] LJSC, Article 56, Clause 1, Paragraph 2.

[177] FCSM Regulation No. 17/ps, Section 4.6.

- Shareholders, or shareholder representatives who did not return voting ballots; and
- Shareholders, or shareholder representatives who acquired shareholder rights due to the reorganization of the company or death of a shareholder.

c) What Documents Must Be Verified for the Registration

To register participants of the AGM, the registering body must verify:[178]

- The identity of the participants;
- That participants are on the shareholder list; and
- That shareholder representatives, or proxies, have a valid power of attorney.

d) Registration of Participants and Voting Ballots

The registering body must provide voting ballots to participants after registration is complete, unless voting ballots were sent prior to the AGM.

e) The Time for the Registration of Participants

The registration of participants of the AGM officially starts at the time stated in the notice of the AGM and ends after the discussion of the last agenda item.[179]

Best Practices: The registration of participants should be carried out on the same day just prior to conducting of the AGM.[180] Poorly organized registration may result in shareholders having to wait in line while the AGM starts. Accordingly, companies should make every effort to ensure that the registration process is quick and efficient, and that participants are not prevented from participating in the AGM due to administrative delays. This means that the registration desk needs to be adequately staffed, and open well in advance of the AGM.

[178] FCSM Regulation No. 17/ps, Section 4.8.

[179] FCSM Regulation No. 17/ps, Section 4.9, Paragraph 1.

[180] FCSM Code, Chapter 2, Section 2.2.2.

f) Where Participants Must Be Registered

Registration must take place where the AGM is held.[181]

3. Verifying and Announcing the Quorum

The Counting Commission must verify and announce that a quorum is present for the AGM after registration is complete and before shareholders may vote.[182]

Owners of more than 50% of voting shares must participate in the AGM for it to commence and its decisions to be valid.[183] The shareholders participating in the AGM are those who:

- Are registered (in person or by proxy); or
- Have returned voting ballots no later than two days prior to the AGM.[184]

If the agenda of the AGM includes items with different voting requirements for common shareholders and preferred shareholders, a quorum must be determined separately for each item. The absence of a quorum for any one agenda item does not prevent shareholders from voting on other agenda items for which a quorum exists.[185] A quorum must be re-verified for each agenda item.[186]

A quorum is verified by counting the number of registered shares. Fractional shares must be counted for a quorum, and may not be rounded off.[187]

The Chairman opens the AGM when there is a quorum for at least one agenda item. If there is no quorum, the AGM must be postponed in accordance with the charter or by-laws. The AGM may not be postponed for more than two hours.[188] If the charter or by-laws do not specify how long the AGM may be postponed, it must be postponed for only one hour. The AGM may be postponed only once.

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[181] FCSM Regulation No. 17/ps, Section 4.5.

[182] LJSC, Article 56, Clause 4.

[183] LJSC, Article 58, Clause 1, Paragraph 1.

[184] LJSC, Article 58, Clause 1, Paragraphs 1 and 2.

[185] LJSC, Article 58, Clause 2.

[186] FCSM Regulation No. 17/ps, Section 4.11.

[187] FCSM Regulation No. 17/ps, Section 4.15.

[188] FCSM Regulation No. 17/ps, Section 4.9, Paragraphs 2 and 3.

In the absence of a quorum for at least one agenda item, the AGM must be rescheduled. The rescheduled AGM must be conducted with the same agenda.[189]

The rescheduled AGM may be conducted and will be deemed valid if the owners of not less than 30% of voting shares participate in the rescheduled AGM.[190] The charter of a company with more than 500,000 shareholders with voting rights may set a lower quorum requirement for any rescheduled AGM.

Best Practices: Charters of companies with more than 500,000 shareholders (with voting rights) should require the registration of no less than 20% of voting shares for a rescheduled AGM.[191]

If the rescheduled AGM is held within 40 days of the original AGM, it is not necessary to prepare a new shareholder list.[192] The rescheduled AGM may only be held if persons included on the shareholder list are notified in a timely manner according to procedures for the original AGM.[193]

4. Opening the Annual General Meeting of Shareholders

The AGM may be opened if a quorum exists on at least one agenda item. The person who opens the AGM, typically the Chairman of the Supervisory Board, must invite shareholders to vote on:

- The Counting Commission members if their terms have expired;
- The AGM Chairman (unless the charter defines who presides over the GMS);[194] and
- The AGM Secretary (unless the charter defines who the Secretary is).

[189] LJSC, Article 58, Clause 3, Paragraph 1.

[190] LJSC, Article 58, Clause 3, Paragraphs 1 and 2.

[191] FCSM Code, Chapter 2, Section 2.3.

[192] LJSC, Article 58, Clause 4.

[193] LJSC, Article 58, Clause 3, Paragraph 3.

[194] LJSC, Article 67, Clause 2.

5. Electing the Counting Commission

The AGM must elect Counting Commission members when the company has more than 100 shareholders with voting rights and the term of the previous Counting Commission has expired.[195]

If the company has more than 500 shareholders with voting rights, an External Registrar must perform the functions of the Counting Commission.[196] A company with 500 or fewer shareholders with voting rights may voluntarily retain an External Registrar to perform the functions of the Counting Commission.[197]

The functions of the Counting Commission may also be assigned to an External Registrar when:[198]

- The terms of Counting Commission members have expired; or
- The number of its members is less than three; or
- Fewer than three Counting Commission members are present at the AGM.

There are no term-limits for Counting Commission members.

Figure 11 depicts the various responsibilities of the Counting Commission.[199]

The Counting Commission must have at least three members.[200] To ensure that it performs its functions independently of the General Director, the Executive Board, and the Supervisory Board, the following individuals may not be members:[201]

- Supervisory Board members, and candidates for the Supervisory Board;
- Revision Commission members, and candidates for the Revision Commission;
- The General Director, and candidates for the position of General Director;
- Executive Board members and candidates for the Executive Board; and
- The External Manager, and candidates for the External Manager.

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195 LJSC, Article 56, Clause 1.

196 LJSC, Article 56, Clause 1.

197 LJSC, Article 56, Clause 1, Paragraph 2.

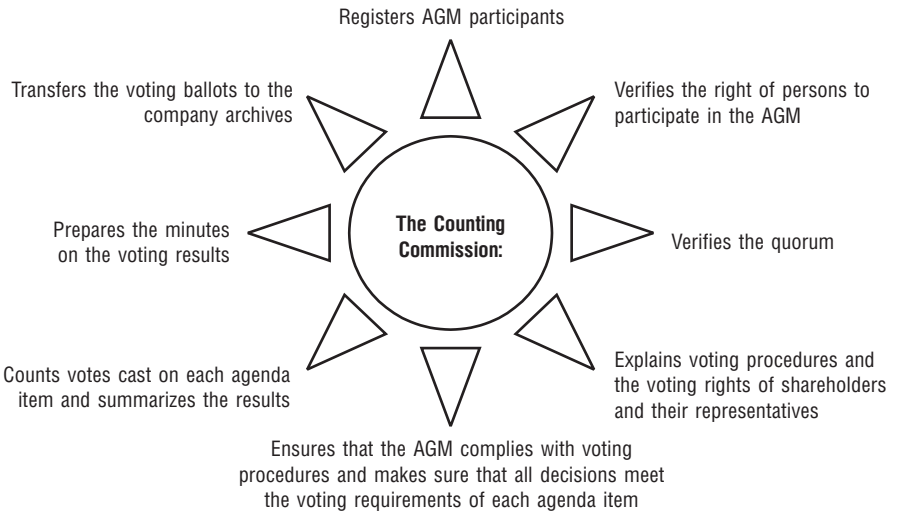
198 LJSC, Article 56, Clause 3.

199 LJSC, Article 56, Clause 4.

200 LJSC, Article 56, Clause 2.

201 LJSC, Article 56, Clause 2.

Figure 11: The Functions of the Counting Commission



Source: IFC, March 2004

6. Electing the Chairman of the Annual General Meeting of Shareholders

The Chairman of the Supervisory Board presides over the AGM if the charter does not provide otherwise.[202] In all other cases, shareholders must elect the AGM Chairman.

7. Electing the Secretary of the Annual General Meeting of Shareholders

The AGM must have a Secretary.[203] The AGM Secretary ensures that discussions and decisions are duly recorded in the AGM minutes. Shareholders elect the AGM Secretary if the charter does not define who the Secretary is or when his term expires.

Best Practices: A qualified Corporate Secretary is an excellent candidate to serve as the AGM Secretary.[204]

[202] LJSC, Article 67, Clause 2.

[203] LJSC, Article 63, Clause 1.

[204] FCSM Code, Chapter 5, Section 1.1.7.

8. Inviting Outside Guests as Observers

As a practical matter, the company may invite creditors, potential investors, employees, government officials, journalists, experts, and other individuals and organizations that do not own company shares to the AGM. The charter and by-laws may specify procedures on inviting guests to the AGM.

9. Presenting the Agenda and the Rules of Order

The Chairman of the AGM presents the agenda to the AGM participants. In addition, the AGM Chairman explains the rules of order as specified either in the charter, by-laws or a decision of the GMS. Per request of the AGM Chairman, the Counting Commission explains the voting procedures.

10. Discussing Agenda Items

The AGM Chairman may invite Supervisory Board members, the General Director, and Executive Board members to comment on agenda items before the shareholders vote. He may also ask invited experts to explain agenda items to shareholders.

Best Practices: It is good practice that:[205]

- Shareholders have the opportunity to question Revision Commission members and the External Auditor;
- Shareholders receive clear answers to questions;
- Questions from shareholders are answered immediately. If a question cannot be answered immediately, a written response should be given as soon as possible after the AGM;
- The AGM be conducted so that all shareholders have an opportunity to make balanced and informed decisions on all agenda items;
- The External Auditor, the General Director, and members of the Supervisory Board, the Revision Commission, and the Executive Board are present at the AGM. If they are not, the AGM Chairman should explain their absence;
- Key officers of the company, including the chairmen of Supervisory Board committees, speak at the AGM;
- The agenda set aside some time for presentations by shareholders; and
- The Chairman of the AGM interrupt speakers only to maintain order or comply with procedural requirements.

[205] FCSM Code, Chapter 2, Section 2.1.

11. Voting

After one or several agenda items have been thoroughly discussed, the Chairman of the AGM invites shareholders to vote. Voting is based upon the principle of "one voting share — one vote," except for cumulative voting when directors are elected[206] or when the charter includes voting limitations.[207]

Shareholders have the right to vote on all agenda items from the moment the AGM is opened until the moment it is closed when voting results are not announced during the AGM.[208]

When the charter, by-laws, or a decision of the AGM requires voting results to be announced during the AMG, all shareholders have the right to vote on all agenda items from the moment the AGM is opened until the counting of votes begins.[209]

The format of a ballot depends on the voting procedures. Ballots document how shareholders voted on agenda items. Further, they may help shareholders to prove how they voted in the event that there are subsequent legal actions. The ballot is typically a document that:

- Contains all agenda items on which shareholders may vote. In this case, the Counting Commission presents voting results to the Chairman of the AGM after shareholders have voted on all agenda items; or
- Consists of separate pages, each containing one or several items on which shareholders may vote. In this case, the Counting Commission presents the voting results to the Chairman of the AGM every time that shareholders vote on the items listed on one page.

➜ *For more information on voting ballots, see Section B.4.f of this Chapter.*

A ballot is valid if a shareholder marks only one of the possible options for a particular item.[210] A failure to do so invalidates the ballot with regard to that item.

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[206] LJSC, Article 59.

[207] LJSC, Article 11, Clause 3.

[208] FCSM Regulation No. 17/ps, Section 4.10.

[209] FCSM Regulation No. 17/ps, Section 4.10.

[210] LJSC, Article 61.

Improperly completed voting ballots with respect to one or more items do not cause the voting ballot to be invalid for other agenda items.

Best Practices: The procedure for counting votes should be transparent. To avoid any (perception) that the voting results have been manipulated, the Counting Commission be should independently monitored when counting votes. The charter and other internal regulations should provide for such monitoring and, additionally, define the authority of those persons appointed to monitor the counting process.[211]

12. Counting and Documenting Votes

The Counting Commission must count the number of votes cast during the AGM and summarize voting results in its minutes. The Counting Commission presents the voting results to the Chairman of the AGM, who then announces the results (if the company decides to announce results immediately).

The FCSM requires that the Counting Commission minutes contain specific information.[212]

➜ *See Section C.18 of this Chapter.*

All Counting Commission members must sign the minutes on the voting results.[213] If the External Registrar performs the functions of the Counting Commission, the person(s) authorized by the Registrar must sign the minutes.[214]

13. Announcing the Voting Results and Decisions

The Chairman of the AGM announces the voting results by reading the Counting Commission minutes and the AGM decisions.[215]

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[211] FCSM Code, Chapter 2, Section 2.4.2.

[212] FCSM Regulation No. 17/ps, Section 5.3.

[213] LJSC, Article 62, Clause 1.

[214] FCSM Regulation No. 17/ps, Section 5.4.

[215] LJSC, Article 62, Clause 4.

Best Practices: The voting results should be counted and announced prior to the closing of the AGM.[216]

14. Closing the Annual General Meeting of Shareholders

The Chairman of the AGM closes the AGM when:

- All agenda items have been discussed and voted upon; and
- The voting results have been announced (if the company decides to announce results immediately).

An AGM may not be closed if a quorum does not exist on outstanding agenda items by the end of the registration.[217]

Best Practices: The company should close the AGM on the same day to avoid unnecessary (extra) expenses for shareholders. If the AGM cannot be completed within one day, the company should continue the Meeting on the next day.[218]

15. Archiving Voting Ballots

After the AGM, the Counting Commission must ensure that the voting ballots are sealed and transferred to the archives.[219]

16. Preparing the Annual General Meeting of Shareholders Minutes

The company must prepare the AGM minutes within 15 days of its closure.[220] The AGM Chairman and Secretary must each sign two original copies of the minutes.

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[216] FCSM Code, Chapter 2, Section 2.4.3.

[217] FCSM Regulation No. 17/ps, Section 4.11.

[218] FCSM Code, Chapter 2, Section 2.4.1.

[219] LJSC, Article 62, Clause 2.

[220] LJSC, Article 63, Clause 1.

The AGM minutes must include specific information.[221]

➜ *For more information on the information that must contained in the AGM minutes, see Section C.18 of this Chapter.*

The AGM minutes are inserted in the minute book. The company must provide a copy of the AGM minutes to shareholders upon request.[222] Shareholders may be asked to reimburse the company for reasonable copying costs.[223]

The following documents must be attached to the AGM minutes:[224]

- The Counting Commission minutes on the voting results; and
- Documents approved by the AGM.

17. Notifying Shareholders of Voting Results and Decisions (After the Annual General Meeting of Shareholder)

If the voting results are not announced during the AGM, shareholders should receive a report detailing the results no later than 10 days after the minutes on the voting results are drafted.[225] The report on the voting results should contain the information specified in Section C.18 below, and should be signed by the Chairman and Secretary of the AGM.[226] The company should follow the same procedure as required for notifying shareholders of the AGM.

18. Documents of the Annual General Meeting of Shareholder

Table 4 presents a summary of information that must be included in the Counting Commission minutes on the voting results, as well as the AGM minutes (regardless of whether the results are announced during or after the AGM). It also covers the information required in the report on the voting results that must be furnished to shareholders in the event that decisions are not announced during the AGM.

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[221] LJSC, Article 63, Clause 2; FCSM Regulation No. 17/ps, Section 5.1.

[222] LJSC, Article 91, Clause 1.

[223] LJSC, Article 52, Clause 3, Article 91, Clause 2.

[224] LJSC, Article 62, Clause 3; FCSM Regulation No. 17/ps, Section 5.2.

[225] LJSC, Article 62, Clause 4.

[226] FCSM Regulation No. 17/ps, Section 5.6.

Table 4: Information Related to the Results of the AGM

Information	Must Be Included in:		
	The Minutes on the Voting Results	The AGM Minutes	The Report on the Voting Results
Full name and location of the company	✓	✓	✓
AGM address, i.e. location where it was held	✓	✓	✓
Date of the AGM	✓	✓	✓
Number of votes cast on each agenda item	✓	✓	✓
Number of votes on each agenda item and the required quorum	✓	✓	✓
Agenda	✓	✓	✓
Voting results (number of votes "for," "against," and "abstained" on each agenda item with a quorum)	✓	✓	✓
Type of GMS (AGM or EGM)	✓	✓	✓
Form of AGM (by physical attendance or written consent)	✓	✓	✓
Time when registration of participants started and ended	✓	✓	
Number of votes on each agenda item that were not counted because they were invalid	✓		
Names of Counting Commission members	✓		✓
Full name and location of the External Registrar or of persons authorized by the Registrar to act as the Counting Commission	✓	✓	✓
Date of writing the Counting Commission minutes on the voting results of the AGM	✓		
Name of the AGM Chairman and Secretary		✓	✓

Table 4: Information Related to the Results of the AGM			
Information	Must Be Included in:		
	The Minutes on the Voting Results	The AGM Minutes	The Report on the Voting Results
Text of approved decisions		✓	✓
Summary of speeches and discussions		✓	
Time when the AGM was opened and closed		✓	
Time when the calculation of votes started, if the decisions approved by the AGM and the voting results were announced during the Meeting		✓	
Mailing address of the company to which the completed voting ballots were submitted by shareholders, if the company distributed ballots prior to the AGM		✓	
Date when the AGM minutes were prepared		✓	

D. An Overview of the Extraordinary General Meeting of Shareholders

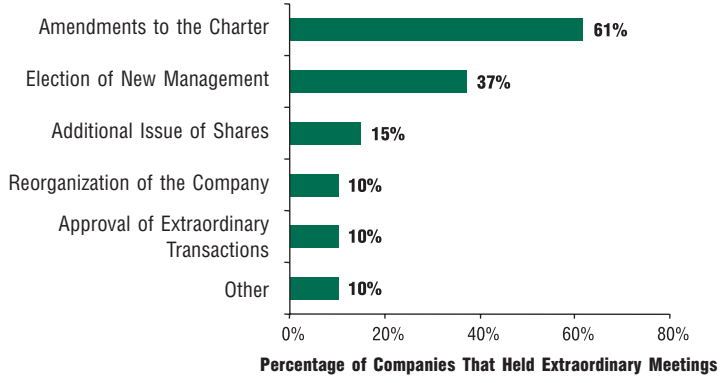
An EGM may be convened for the company to make important decisions between two AGM. The organization of an EGM resembles that of the AGM. The particularities of the organization of an EGM are the focus of this section.

Company Practices in Russia: 38% of companies in Russia's regions conducted an EGM during 2001 and 2002.[227] As depicted in Figure 12, the two most frequent reasons for calling an EGM are: (1) changes to the company charter (61%) and (2) the election of new management (37%). In 70% of the

[227] IFC Survey on Corporate Governance Practices in Russia's regions, Section 2.3.1, page 34, August 2003 (see www.ifc.org/rcgp).

companies holding an EGM, the Supervisory Board called the Meeting. Shareholders called an EGM in only 6% of companies. In only one case did a Revision Commission initiate an EGM.

Figure 12: Reasons for Calling an EGM



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

1. When to Conduct an Extraordinary General Meeting of Shareholders

An EGM may be called under a number of different circumstances:

a) When Required by Law

The Supervisory Board is required by law to conduct an EGM when:

- The Supervisory Board is unable to perform its duties due to the lack of a quorum, i.e. when the number of serving members becomes less than the quorum as specified by the charter;[228] or
- The executive bodies are suspended or unable to perform their duties as shown in Table 5.

[228] LJSC, Article 68, Clause 2.

Table 5: When the Supervisory Board is Required to Conduct an EGM[229]	
Circumstances	**Agenda Items**
The Supervisory Board suspends the authority of the General Director and appoints an interim General Director[230]	The election of a new General Director
The Supervisory Board appoints an interim General Director because he cannot perform his duties due to illness, death, resignation, etc.[231]	The election of a new General Director
The Supervisory Board suspends the authority of the External Manager and appoints an interim General Director[232]	The approval of the External Manager/General Director
The Supervisory Board appoints an interim General Director because the External Manager cannot perform the duties of the General Director due to illness, death, resignation, or the liquidation and bankruptcy of the Managing Organization	The approval of the External Manager/General Director
The number of serving Executive Board members becomes less than the quorum as specified by the charter[233]	The election of a new Executive Board

b) Who May Request an Extraordinary General Meeting of Shareholders

A number of parties have the right to request an EGM, including:[234]

- The Revision Commission;
- The External Auditor; and

[229] LJSC, Article 69, Clause 4, Paragraphs 3 and 4; Article 70, Clause 2, Paragraph 1.

[230] The Supervisory Board has this authority when the establishment of executive bodies falls within the authority of the GMS, and the charter provides that the Supervisory Board has the authority to suspend the powers of the General Director and to appoint an interim General Director.

[231] The Supervisory Board has this authority when the establishment of executive bodies falls within the authority of the GMS.

[232] The Supervisory Board has this authority when the charter provides that the Supervisory Board has the right to suspend the powers of the external manager and to appoint an interim General Director.

[233] The Supervisory Board has this authority when the establishment of the Executive Board falls within the authority of the GMS.

[234] LJSC, Article 55, Clause 1, Paragraph 1.

- A shareholder (or a group of shareholders) owning at least 10% of voting shares.

The power to request an EGM is an important shareholder right. Though rarely exercised in practice, it allows the controlling bodies of the company to convene an EGM when they deem it necessary and appropriate.

2. Preparatory Procedures

An EGM and AGM have some procedural differences. These differences relate to the drafting of the agenda, timing requirements for notifying shareholders, and providing access to documents (information).

a) Initiating Preparation

The Supervisory Board initiates preparations if required by the Company Law or at its own discretion. When the request to convene an EGM comes from another party, the Company Law prescribes the following procedure:

- The Supervisory Board must review the request within five days;[235]
- The Supervisory Board decides to hold the EGM. The decision of when to hold the EGM will differ, in part, according to whether or not the agenda involves cumulative voting for directors;[236] and
- The Supervisory Board must notify the requesting party within three days of the decision.[237]

The Supervisory Board has the right to reject the request when:[238]

- The request to conduct the EGM is inconsistent with the requirements of the Company Law;
- A shareholder (or a group of shareholders) does not own at least 10% of voting shares; or
- The proposed agenda items do not fall within the authority of the EGM and/or the proposal is inconsistent with legal requirements.

Rejection may be appealed to the courts.[239]

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[235] LJSC, Article 55, Clause 6, Paragraph 1.

[236] LJSC, Article 55, Clause 2, Paragraphs 1 and 2.

[237] LJSC, Article 55, Clause 7, Paragraph 1.

[238] LJSC, Article 55, Clause 6, Paragraph 2.

[239] LJSC, Article 55, Clause 7, Paragraph 2.

When the Supervisory Board makes no decision or decides to reject conducting an EGM, the requesting party has the right to conduct the EGM without the Supervisory Board's consent. In this case, the requesting party has the same rights and obligations as the Supervisory Board with respect to preparing and conducting the EGM.[240] The company may be required to reimburse the expenses of the requesting party by a decision of the EGM.[241]

b) Drafting the Agenda

The initiating party, i.e. the Supervisory Board or the requesting party, drafts the agenda of the EGM.

The agenda may include different items, including the election of directors. However, in the event that the number of directors becomes less than the quorum as specified by the charter, the agenda of the EGM may only include a single item, that to elect the new Supervisory Board. For another mandatory EGM, the agenda may include additional items.

c) Specific Requirements Depending on the Agenda Item

Different time periods exist for different procedural steps, depending on whether the election of Supervisory Board members, which must be conducted by cumulative voting, is on the agenda. These differences are summarized in Table 6.

Table 6: Specific Timelines for an EGM

	Cumulative Voting	Standard Voting or Other Agenda Items
Maximum period between the decision to conduct a mandatory EGM and the Meeting	70 days	40 days
Maximum period between the request to conduct a voluntary EGM and the Meeting	70 days	40 days
The record date is not earlier than (and no later than)	65 days (45 days)	50 days (45 days)
The notification of shareholders is not later than	50 days	20 days (30 days in case of reorganization)

[240] LJSC, Article 55, Clause 8, Paragraph 1.

[241] LJSC, Article 55, Clause 8, Paragraph 2.

3. Conducting the Extraordinary General Meeting of Shareholders by Written Consent

The EGM may be held by written consent.[242] The EGM is held by written consent when shareholders do not have the opportunity to attend the EGM, and discuss and vote on agenda items. This is mainly useful when the EGM must make decisions on administrative matters, for example, increasing the number of Counting Commission members.

The section below describes the specific Company Law requirements in relation to an EGM conducted by written consent.

a) Decision-Making Powers of an Extraordinary General Meeting of Shareholders Held by Written Consent

An EGM held by written consent may decide all issues that fall within the GMS authority except for:[243]

- The election of Supervisory Board members (mandatory and voluntary);
- The election of Revision Commission members;
- The approval of the External Auditor; and
- The approval of the annual report, financial statements, the distribution of profits, and the payment of dividends.

An EGM by written consent may not be held in place of an AGM that is rescheduled because of the lack of a quorum.

b) Additional Information

Certain information, in addition to that available at an AGM, must be provided to shareholders in the notification, the voting ballot, and the EGM minutes, such as the deadline for accepting voting ballots and the mailing address to which completed ballots should be sent.[244]

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[242] LJSC, Article 50, Clause 1.

[243] LJSC, Article 50, Clause 2.

[244] LJSC, Article 52, Clause 2; Article 60, Clause 4, Paragraph 1; FCSM Regulation No. 17/ps, Section 5.1.

c) The Date and Quorum of an Extraordinary General Meeting of Shareholders Held by Written Consent

The date on which an EGM is held by written consent is also the deadline for accepting voting ballots.[245]

An EGM by written consent is valid if the owners of more than 50% of voting shares participate. The shareholders who participate are those whose completed ballots have been received by the deadline.[246]

E. Decisions of the General Meeting of Shareholders

It is important to follow procedures for preparing and conducting the GMS to ensure the validity and lawfulness of decisions reached by this governing body.

1. Decisions Requiring a Simple Majority Vote

Most decisions of the GMS can be approved by a simple majority vote of participating shareholders, as depicted in Table 7.[247]

Table 7: Decisions that Require a Simple Majority Vote	
Decisions Related to the Governance of the Company	**Reference**
Approve the by-laws for the company's Supervisory Board, and executive bodies	LJSC, Article 48, Clause 1, Section 19
Approve the by-law for the Revision Commission	LJSC, Article 85, Clause 2, Paragraph 2
Determine the list of additional documents that must be kept by the company	LJSC, Article 89.
Related to the Supervisory Board, General Director, and Executive Board	
Approve the remuneration of Supervisory Board members	LJSC, Article 64, Clause 2
Appoint and dismiss the General Director and Executive Board members	LJSC, Article 48, Clause 1, Section 8

[245] FCSM Regulation No. 17/ps, Section 4.19.

[246] LJSC, Article 58, Clause 1, Paragraph 2.

[247] LJSC, Article 49, Clause 2, Paragraph 1.

Table 7: Decisions that Require a Simple Majority Vote	
Transfer (and terminate the transfer) of the General Director's authority to the External Manager	LJSC, Article 69, Clause 1, Paragraph 3
Related to the Audit Function	
Request an extraordinary inspection of the financial and economic activities of the company by the Revision Commission	LJSC, Article 85, Clause 3, Paragraph 1
Elect and dismiss Revision Commission members or the individual performing the functions of the Revision Commission	LJSC, Article 48, Clause 1, Section 9
Approve the terms of compensation and reimbursement of Revision Commission members	LJSC, Article 85, Clause 1, Paragraph 2
Appoint the External Auditor	LJSC, Article 48, Clause 1, Section 10
Approve annual reports, annual financial statements, including profit and loss statements, the distribution of profits and losses, and the payment of dividends	LJSC, Article 48, Clause 1, Section 11
Related to Shareholder Rights	
Declare and pay dividends	LJSC, Article 48, Clause 1, Section 10.1
Establish procedures for the organization of the GMS if this is provided be the charter or by-laws	LJSC, Article 48, Clause 1, Section 12
Elect and dismiss Counting Commission members	LJSC, Article 48, Clause 1, Section 13
Determine the number of Counting Commission members	LJSC, Article 56, Clause 1
Approve the reimbursement of expenses if the EGM is conducted by parties other than the Supervisory Board	LJSC, Article 55, Clause 8
Increase the charter capital by increasing the nominal value of issued shares	LJSC, Article 48, Clause 1, Section 6
Increase the charter capital by issuing additional shares (if this power has not been delegated to the Supervisory Board by the charter)	LJSC, Article 48, Clause 1, Section 6; Article 39, Clause 4

Table 7: Decisions that Require a Simple Majority Vote	
Reduce the charter capital by decreasing the nominal value of placed shares or by reducing the number of placed shares by retiring treasury shares	LJSC, Article 48, Clause 1, Section 7
Decrease or increase the nominal value of shares (split or consolidate shares)	LJSC, Article 48, Clause 1, Section 14
Approve related party transactions in cases specified by the Company Law (only by shareholders who are not interested parties in a transaction)	LJSC, Article 48, Clause 1, Section 15
Approve extraordinary transactions involving 50% or less of the book value of company assets	LJSC, Article 48, Clause 1, Section 16
Waive the obligation of the controlling shareholders to make a mandatory bid in case of control transactions	LJSC, Article 80, Clause 2, Paragraph 2
Issue bonds or other convertible securities through open subscription if these bonds and other securities may be converted into 25% or less of already issued common shares (if this power has not been delegated to the Supervisory Board by the charter)	LJSC, Article 33, Clause 2, Paragraph 2
Participate in holding companies, financial industrial groups, associations, or other groupings of commercial entities	LJSC, Article 48, Clause 1, Section 18

2. Decisions Requiring a Supermajority Vote

a) Per the Company Law

Table 8 summarizes decisions that must be approved by a ¾-majority vote of participating shareholders.[248]

Table 8: Decisions Requiring a ¾-Majority Vote	
Decisions	**References**
Amend the charter or approve a new version of the charter	LJSC, Article 48, Clause 1, Section 1
Reorganize the company	LJSC, Article 48, Clause 1, Section 2

[248] LJSC, Article 49, Clause 4.

Table 8: Decisions Requiring a 3/4-Majority Vote	
Decisions	**References**
Liquidate the company and appoint Liquidation Committee members	LJSC, Article 48, Clause 1, Section 3
Approve the interim and final liquidation balance sheets	LJSC, Article 48, Clause 1, Section 3
Determine the number, nominal value, types, and classes of authorized shares	LJSC, Article 48, Clause 1, Section 5
Approve extraordinary transactions involving more than 50% of the book value of company assets	LJSC, Article 79, Clause 3
Approve the buy-back by the company of its issued shares	LJSC, Article 48, Clause 1, Section 17

b) Per the Charter

Some GMS decisions must be approved by a supermajority vote if specified in the charter, as depicted in Table 9.

Table 9: Decisions Requiring a Supermajority Vote as Per the Charter		
Decision	**Percentage of Votes**	**Reference**
Amend the charter that limit the rights of preferred shareholders	• A 3/4-majority vote of preferred shareholders of a specified class whose rights will be affected as a result of charter amendments (if the charter does not require a higher percentage of votes); and • A separate 3/4-majority vote of all other shareholders with voting rights participating in the GMS (if the charter does not require a higher percentage of votes).	LJSC, Article 32, Clause 4
Issue additional shares through closed subscription	A 3/4-majority vote of shareholders participating in the GMS (if the charter does not require a higher percentage of votes).	LJSC, Article 39, Clause 3

Table 9: Decisions Requiring a Supermajority Vote as Per the Charter		
Decision	**Percentage of Votes**	**Reference**
Issue convertible securities through closed subscription	A 3/4-majority vote of shareholders participating in the GMS (if the charter does not require a higher percentage of votes).	LJSC, Article 39, Clause 3
Issue additional shares through an open subscription that are more than 25% of the outstanding common shares	A 3/4-majority vote of shareholders participating in the GMS (if the charter does not require a higher percentage of votes).	LJSC, Article 39, Clause 4
Issue bonds or other convertible securities through open subscription if such bonds and other securities may be converted into more than 25% of the outstanding common shares	A 3/4-majority vote of shareholders participating in the GMS (if the charter does not require a higher percentage of votes).	LJSC, Article 39, Clause 4

3. Decisions Requiring a Unanimous Vote

The decision to reorganize the company into a non-commercial partnership must be approved by a unanimous vote of all shareholders.[249]

4. Appealing Decisions

Under certain circumstances, GMS decisions may be appealed to (and potentially invalidated by) the courts. Decisions may be appealed when legal and/or charter requirements have not been met.[250] GMS decisions may be appealed by:

- A shareholder (or a group of shareholders) who did not participate in the GMS that approved the decision that is being appealed; or
- A shareholder (or a group of shareholders) who voted against the approval of the decision that is being appealed; if
- The decision violates his rights and lawful interests.

A decision of the GMS may be appealed within six months from the date the shareholder knew (or should have known) about the decision.

[249] LJSC, Article 20, Clause 1, Paragraph 2.

[250] LJSC, Article 49, Clause 7.

The court may leave the contested decision intact when the:

- Vote of the claimant would not have changed the outcome; and
- Violation of the legal and/or the charter requirements are not significant; and
- Decision caused no losses to the claimant.

The following violations are significant enough to revoke a decision taken by the GMS:[251]

- Failure to provide timely notice of the GMS to all shareholders;
- Depriving the shareholder of the opportunity to familiarize himself with the materials for the GMS; or
- Failure to distribute voting ballots on a timely basis.

Even if a shareholder did not file a claim, the court can still invalidate a decision of the GMS, under the following conditions:[252]

- Parties in another court proceeding base their arguments on a particular decisions of the GMS; and
- The court learns that the decision has been approved in violation of the GMS' authority; or
- The GMS lacked a quorum; or
- The issue in question was not included in the agenda.

F. The General Meeting of Shareholders in Companies with a Single Shareholder

When the company has only one shareholder who possesses all of the voting rights, this shareholder may make all decisions that fall within the authority of the GMS. All decisions must be approved in writing by the single shareholder.[253] The procedures established by the Company Law for preparing and conducting the GMS do not apply to a company with a single shareholder, except for the requirement that the AGM must be held no earlier than two months and no later than six months after the end of the fiscal year.

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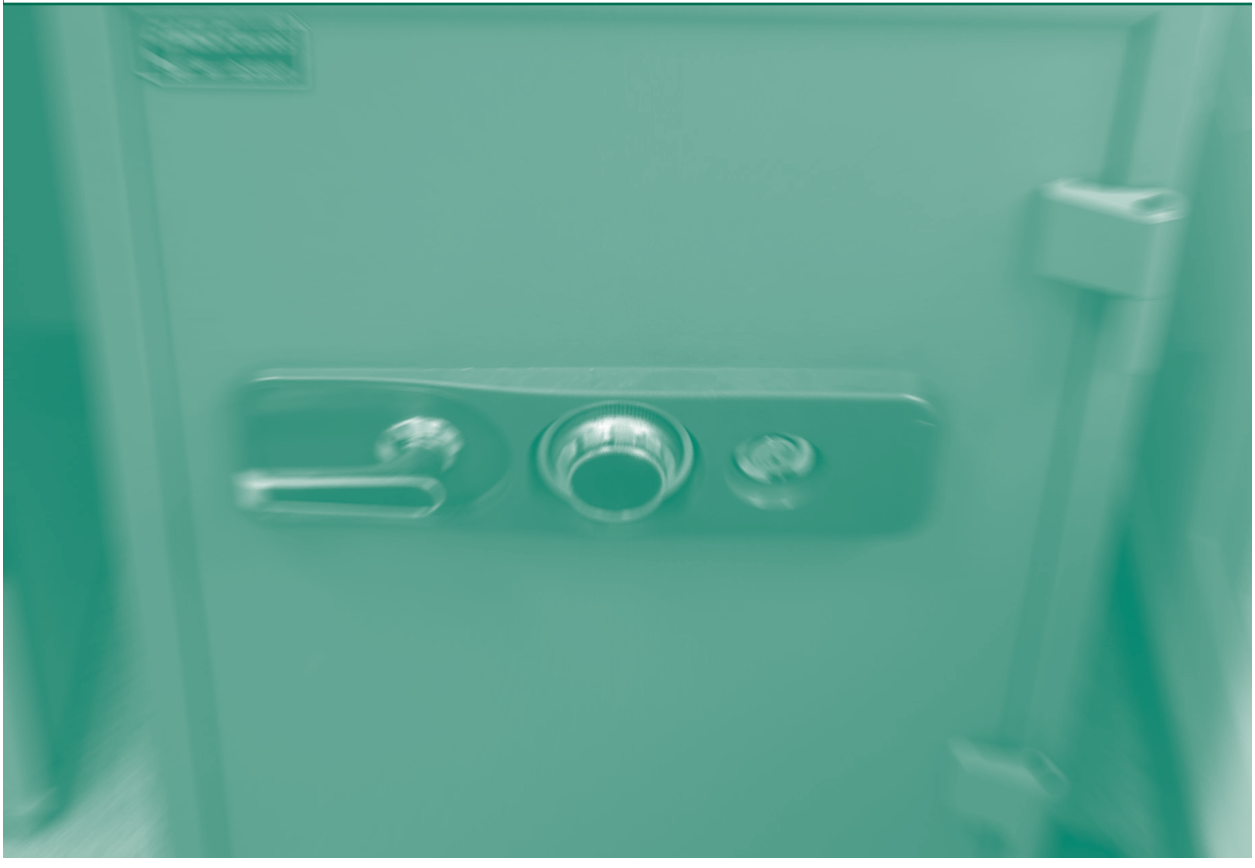
[251] Resolution No. 19 of the Plenum of the Supreme Arbitration Court, on Certain Issues of Application of the Law on Joint Stock Companies (Resolution No. 19), 18 November 2003, Section 24.

[252] Resolution No. 19, Section 26.

[253] LJSC, Article 47, Clause 3.

Chapter 9

Corporate Governance **Implications** of the **Charter Capital**



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The Chairman's Checklist

- ✓ Has the Supervisory Board ensured that the company's founders have paid their initial contributions and that in-kind contributions have been properly valued?
- ✓ Does the Supervisory Board understand the financial needs of the company and the different techniques of corporate finance? Is the Supervisory Board authorized to increase the charter capital? Is the Supervisory Board careful not to dilute the ownership of shareholders?
- ✓ Are capital increases justified?
- ✓ Does the Supervisory Board ensure that the charter capital and consequently the creditors are adequately protected in cases of charter capital decreases? In such cases, does the Supervisory Board make decisions regarding the buyback of company shares? Has the Supervisory Board ensured that all shareholders who submit their shares are treated equitably?
- ✓ How does the Supervisory Board ensure that the reserve fund is utilized in the best interests of the company? What other funds has the company established?

The concept of charter capital is still largely embedded in continental European law. The same holds true for Russia. The Company Law in particular attaches certain protective functions to charter capital, protecting shareholders from dilution and providing a minimum guarantee that obligations toward company creditors will be fulfilled. Although the charter capital per se cannot fulfill that role, it is still considered one of the elements guaranteeing the interests of creditors. Regarding shareholders, the charter capital plays an important role since many shareholder rights are directly linked to the size of their investment in the charter capital.

Charter capital has a legal, rather than economic meaning. It only exists in accounting terms, as fixed in the balance sheet. For this reason, its protective function is often criticized as a formality. Regardless, it is a legal requirement when establishing and operating a company. Legislation provides for certain rules

that govern both increases and decreases in the charter capital. In addition, there are other procedural guarantees of shareholder and creditor rights, such as the buyback by the company of its own shares, the redemption of shares, reciprocal shareholdings, and the maintenance of statutory reserves, all of which are discussed in this chapter.

A. General Provisions Related to the Charter Capital

The charter capital is an important element of the legal definition of a joint stock company, which is defined as a commercial entity, whose charter capital is divided into a specified number of shares, certifying the company participants' (shareholders') rights in relation to the company.[254] The charter capital has important legal implications for:

- Determining the minimum amount of a shareholder's liability;[255]
- Determining shareholder rights in relation to their proportionate share in the charter capital; and
- Offering support to protect creditor rights by setting the minimum amount of assets a company must have; this is one of the legal instruments upon which creditors can rely when seeking to ensure that the company will fulfill its contractual obligations.[256]

1. The Definition of Charter Capital

The charter capital is defined as the par value of the company's shares that are issued and outstanding.[257] Only shares that have been issued comprise the charter capital. This includes treasury shares, i.e. shares repurchased by the company for re-sale or for retirement that are issued but not outstanding. Bonds and other credit instruments are not part of the charter capital.

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[254] Civil Code (CC), Article 96, Clause 1; Law on Joint Stock Companies (LJSC), Article 2, Clause 1, Paragraph 1.

[255] LJSC, Article 2, Clause 1, Paragraph 2.

[256] LJSC, Article 25, Clause 1, Paragraph 3.

[257] LJSC, Article 25, Clause 1.

The total amount of the charter capital cannot exceed a maximum of 25% preferred shares and must contain a minimum of 75% common shares.[258]

2. Minimum Charter Capital

Legislation requires that every company have minimum charter capital of at least 1,000 times the minimum monthly wage (effective on the date of the company's state registration).[259] This amount is intended to dissuade smaller undertakings from registering as joint stock companies, and provide start-up capital to newly established companies that cannot be distributed to shareholders.

3. Charter Capital and Authorized Shares

The Company Law provides that the charter may specify the number and nominal value of authorized shares of each type and class, as well as the rights attached to them.[260] Authorized shares are the maximum number of shares of any class that a company may create under the terms of its charter, in addition to already issued shares.

The company is not required to issue all shares it has authorized. If the company chooses not to issue authorized shares, these shares are referred to as authorized but not issued. Only those shares that are issued constitute the charter capital.

A shareholder vote is required to increase the number of authorized shares. In order to avoid costly and time-consuming GMS organization procedures every time the company seeks additional capital, a company may issue some of its authorized but previously un-issued shares by a Supervisory Board decision.

The total authorized capital that a company sets forth in its charter is based upon the amount of money that the company requires at its establishment and the percentage of dilution its founders are willing to accept in the future.

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[258] LJSC, Article 25, Clause 2.

[259] LJSC, Article 26; The Law on the Minimum Amount of Payment for Labor, Article 4. Currently, the minimum monthly wage is set at RUR 100.

[260] LJSC, Article 27, Clause 1, Paragraph 2.

Best Practices: Good corporate governance practice stipulates that the charter should authorize the Supervisory Board to increase the charter capital by issuing authorized shares. When doing so, the charter should include the following information:

- Maximum number of authorized shares. In general, the maximum amount must not exceed 100% of the charter capital at the moment of the authorization for the Supervisory Board to issue authorized shares;
- Types and classes of authorized shares; and
- Form of payment for additionally issued shares.

4. Full Payment for Shares

Shares issued and placed during the establishment of the company must be paid in full within one year from the moment of the company's state registration, unless the founders' contract provides for a shorter period.[261] Full payment should guarantee that shareholders contribute the minimum amount of assets and that the charter capital is duly formed. If shares have not been fully paid upon expiration of a specified period, the unpaid shares must be returned to the company. The founders' contract may also provide penalties in cases of non-payment or failure to pay in full. At least 50% of the shares placed to the founders at the establishment of the company must be paid within three months after the company's state registration.[262] The company is prohibited from engaging in any activity, other than those related to the establishment of the company, before receiving payment for 50% of the shares.[263]

5. Contributions to the Charter Capital

The form of payment for shares during the establishment of the company must be specified by the founders' contract.[264] In general, the shares issued during the estab-

[261] LJSC, Article 34, Clause 1.

[262] LJSC, Article 34, Clause 1, Paragraph 2.

[263] LJSC, Article 2, Clause 2, Paragraph 2. This provision is unclear as to whether these shares have to be paid in full and who is responsible for verifying that full payment has been made.

[264] LJSC, Article 34, Clause 2.

lishment of the company can be paid with money or contributions in-kind, including shares and securities of other companies, tangible or intangible assets, property rights, and/or other rights that have monetary value.[265] In-kind contributions are, however, subject to certain rules. The valuation of in-kind contributions must be agreed upon by the founders[266] and supported by the valuation of an Independent Appraiser. Founders are prohibited from setting the value of assets, property rights, and other rights at a value higher than that determined by an Independent Appraiser.[267] An Independent Appraiser cannot be a founder, an owner, a shareholder, an employee, a contractor, or any other person affiliated with the company.[268] Any individual (or a legal entity) needs a license to be an Independent Appraiser. An Independent Appraiser must be insured against civil liability.[269]

In addition to the valuation of initial in-kind contributions to the charter capital, an independent appraisal is required when the company:

- Redeems shares;[270]
- Is engaged in a transaction that involves state property;[271]
- Is engaged in mortgage operations;[272] or
- Is engaged in the sale of its assets during bankruptcy.

Best Practices: A company should use a licensed Independent Appraiser to determine the market value of property,[273] value debts, and assess liabilities.[274] An Independent Appraiser can also play an important role in assisting management and shareholders during the company reorganization.

[265] LJSC, Article 34, Clause 2.

[266] LJSC, Article 34, Clause 3, Paragraph 1.

[267] LJSC, Article 34, Clause 3, Paragraph 3.

[268] Law on Appraisal Activity, Article 16.

[269] Law on Appraisal Activity, Article 17.

[270] LJSC, Article 75, Clause 3.

[271] Law on Appraisal Activity, Article 8.

[272] Law on Appraisal Activity, Article 8; Law on Mortgage of Property, Article 14, Clause 1.

[273] LJSC, Article 77, Clause 2, Paragraph 1.

[274] Law on Appraisal Activity, Article 5.

B. Increasing the Charter Capital

A number of different factors, such as market conditions, reorganizations, and growth, may necessitate an increase of charter capital. There are two methods of increasing the charter capital:

- Utilizing external sources, such as when the company attracts financial resources from existing shareholders or third parties; and
- From internal sources when the company uses its own funds to capitalize its internal reserves.

1. Methods of Increasing the Charter Capital

Methods to increase the charter capital are summarized in Table 1.[275]

Table 1: Increasing the Charter Capital

	Issuing additional shares for consideration	Issuing additional shares without consideration	Increasing the nominal value of shares
Source	External	Internal	Internal
Contributors	Shareholders and third parties	The company (using funds available from internal sources as defined by legislation)	The company (using funds available from internal sources as defined by legislation)
Purpose	To attract additional funding. It will, however, dilute the holdings of existing shareholders if they are unwilling/unable to make use of their pre-emptive rights	To pay stock dividends, increase the company's equity, etc.	To pay stock dividends, increase the company's equity, etc.
Recipients of new shares	Existing shareholders and third parties	Only existing shareholders	Only existing shareholders

[275] LJSC, Article 28, Clause 1.

Table 1: Increasing the Charter Capital			
	Issuing additional shares for consideration	**Issuing additional shares without consideration**	**Increasing the nominal value of shares**
Changing the company's ownership structure	Possibly	No	No
Method of share issue	Issue of additional (authorized) shares	Issue of additional (authorized) shares	Issue of shares with a higher nominal value
Method of placement	Subscription (open or closed)	Distribution	Conversion
Approving governing body	The General Meeting of Shareholders (GMS), unless delegated by the charter to the Supervisory Board	The GMS, unless delegated by the charter to the Supervisory Board	The GMS
Pre-emptive rights	Yes	No	No

2. Methods of Placement

There are three methods of placing shares:

1) Distribution of shares among shareholders;
2) Conversion, for example when the company increases the charter capital by increasing the nominal value of issued shares; and
3) Subscription, that is when the company floats shares for consideration.

3. Internal Sources for Increasing the Charter Capital

Depending on the method chosen to increase the charter capital, the company can use the funds of shareholders and/or third parties; it can also choose to capitalize using its internal resources. The company may use the following internal resources for capitalization purposes:[276]

- Additional paid-in capital;
- Special purpose funds of the company that were not used during the previous

[276] FCSM Regulation No. 03-30/ps on the Standards of Security Issue and Registration of Security Prospectuses (FCSM Regulation No. 03-30/ps), 18 June 2003, Section 4.3.2.

year (the reserve fund and the employees' fund cannot however be used for this purpose); and
- Retained earnings/undistributed profits.

When increasing the charter capital from internal sources, the amount of the increase cannot exceed the difference between the amount of the net assets, on the one hand, and, on the other, the sum of the charter capital and the reserve fund as of the date the decision to increase the charter capital is approved.[277]

There are two types of subscription available, as shown in Table 2:[278]

Table 2: Types of Subscription

Open	Closed
• The offer is made to an unlimited number of subscribers; • The charter or legislation cannot limit the subscription.	• The offer is made to a limited number or a pre-determined group of subscribers; • The charter or legislation can limit the subscription.

4. Ownership Rights Protection When Increasing the Charter Capital

The company's ownership structure will likely change if the charter capital is increased from external sources. Issuing additional shares results in the dilution of the ownership rights of existing shareholders. Under certain circumstances, however, existing shareholders may have pre-emptive rights to protect them from dilution.[279]

➜ *For a more detailed discussion on pre-emptive rights, see Chapter 7, Section B.5.*

When increasing the charter capital from internal sources, additional shares must be distributed to all owners of shares of each type and class.[280] In addition, the number of new shares of each type and class that are distributed to each shareholder must be pro rated to the number of shares already held by him.

[277] LJSC, Article 28, Clause 5, Paragraph 2.

[278] LJSC, Article 39, Clause 2, Paragraph 1.

[279] LJSC, Article 40, Clause 1, Paragraphs 1 and 2.

[280] LJSC, Article 28, Clause 5, Paragraph 3; FCSM Regulation No. 03-30/ps, Section 4.3.4.

Consequently, each shareholder who owns fractional shares must receive a proportionate fraction of a full share of the same type and class.[281] However, Russian legislation forbids an increase in the charter capital from internal sources if fractional shares will occur as a result.[282]

5. Procedural Guarantees for Increasing the Charter Capital

Company Law and securities legislation provide detailed procedures that companies must follow in order to increase the charter capital. These procedures are aimed at guaranteeing that shareholder rights are protected. The Federal Commission for the Securities Market (FCSM), by registering share issues, plays an important role in overseeing the legality of the increase, thus enforcing proper corporate governance practices in such cases.

The GMS or the Supervisory Board plays the leading role in increasing the charter capital, depending on the method chosen.

a) The GMS Makes the Decision to Place Shares

The decision to increase the charter capital by increasing the nominal value of issued shares must be approved by the GMS.[283] The GMS also decides to increase the charter capital by issuing additional shares (with or without consideration), unless the charter has delegated this right to the Supervisory Board.[284]

First, if the decision to increase the charter capital by issuing additional shares (with or without consideration) falls within the authority of the GMS, legislation requires that the Supervisory Board place the proposal (or motion) to increase the charter capital on the GMS agenda. Unless the charter provides otherwise, only the Supervisory Board has the right to propose the item for the agenda.[285] A simple majority vote of directors participating in the Supervisory Board meeting must approve the proposal unless the charter or by-laws require a higher percentage of votes.[286]

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[281] FCSM Regulation No. 03-30/ps, Section 4.3.6.

[282] FCSM Regulation No. 03-30/ps, Section 4.3.5.

[283] LJSC, Article 28, Clause 2, Paragraph 1.

[284] LJSC, Article 28, Clause 2, Paragraph 2.

[285] LJSC, Article 49, Clause 3.

Second, the company cannot issue shares unless it has sufficient authorized shares for this purpose.[287] The GMS can simultaneously take the decision to increase the charter capital and the decision to either amend the charter to provide for the respective number of authorized shares or amend the charter provision concerning the number of authorized shares.[288] The GMS decision to increase the charter capital is also called the decision to place shares. The different majority votes required for these decisions are summarized in Table 3.

Table 3: Majority Votes Required for the Decision to Increase the Charter Capital

3/4-Majority in the Case of:[289]	Simple Majority in the Case of:[290]
• An issuance of additional common shares representing more than 25% of the total issued common shares through open subscription • An issuance of additional preferred shares which can be converted into common shares representing more than 25% of the total issued common shares through open subscription • Closed subscription	• All other instances

b) The Supervisory Board Decides to Place Shares

In general, the purpose of authorized shares is to enable the company to attract additional capital in an uncomplicated manner. Procedural requirements for increasing the charter capital by the decision of the GMS are cumbersome, time-consuming, and costly. This may make it harder for the company to attract financing quickly in a rapidly changing business environment. For this very purpose, the Company Law permits companies to empower the Supervisory Board to issue authorized shares (with or without consideration). In this case, a unanimous approval of all serving Supervisory Board members is, however, required.[291]

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[286] LJSC, Article 68, Clause 3.

[287] LJSC, Article 27, Clause 1, Paragraph 2.

[288] LJSC, Article 28, Clause 3, Paragraph 2.

[289] LJSC, Article 49, Clause 4; Article 39, Clause 4; Article 32, Clause 4, Paragraph 2. The charter may provide for a higher percentage of votes required for a decision.

[290] LJSC, Article 28, Clause 2; Article 49, Clause 2.

[291] LJSC, Article 28, Clause 2, Paragraph 3.

Best Practices: The Supervisory Board should conduct a meeting where directors are physically present to approve the decision to place shares.[292]

The Supervisory Board may only approve the decision to place shares if the number of additional shares of each type and class to be issued does not exceed the total number of authorized shares of each type and class as set forth in the charter.[293]

c) Information that Must Be Included in the Decision to Place Shares

Depending on the method of placement, the decision to place shares must include the information presented in Table 4.[294]

Table 4: Information that Must Be Included in the Decision to Place Shares

Required Information	Method of Placement		
	Conversion	Distribution	Subscription (Open or Closed)
The types and classes of shares, the nominal value of which will be increased	✓		
The nominal value of shares of each type and class after the increase	✓		
Information that the increase of the charter capital is from retained earnings (if it is so provided)	✓		
The method of placement	✓	✓	✓
The number of shares of each type and class that will be issued within the limits of authorized shares		✓	✓

[292] Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), Chapter 3, Section 4.4.

[293] LJSC, Article 28, Clause 3, Paragraph 1.

[294] LJSC, Article 28, Clause 4; FCSM Regulation No. 03-30/ps, Sections 4.1.3, 5.1.1, 6.1.1 and 6.1.10.

Table 4: Information that Must Be Included in the Decision to Place Shares			
Required Information	**Method of Placement**		
	Conversion	**Distribution**	**Subscription (Open or Closed)**
The price of additional shares, or the procedure to determine the price, of additional shares ➜ *For more information on the placement price, see Chapter 11, Section C.*			✓
The price of additional shares, or the procedure to determine the price, for shareholders who exercise pre-emptive rights			✓
The form of payment for additionally issued shares (if required)			✓
The list of persons (names and/or categories of persons such as the company's employees, shareholders, credit institutions, etc.) to whom the company intends to issue additional shares if the issue takes place through closed subscription			✓

Depending on the method of placement, the decision to place shares can include optional information, as presented in Table 5.[295]

Table 5: Optional Information Included in the Decision to Place Shares			
Optional Information	**Method of Placement**		
	Conversion	**Distribution**	**Subscription (Open or Close)**
The date, or the procedure to determine the date, of placement (the dates of the beginning and end of the period of placement)	✓	✓	✓
The sources from which the increase in charter capital will be paid	✓	✓	

[295] FCSM Regulation No. 03-30/ps, Sections 4.1.3, 5.1.1 and 6.1.1.

Table 5: Optional Information Included in the Decision to Place Shares			
Optional Information	Method of Placement		
	Conversion	Distribution	Subscription (Open or Close)
The procedure and the period for making the payment for additional shares			✓
The procedure for concluding contracts during the placement of additional shares			✓
The number of additionally issued shares that is necessary for the issue to be recognized as completed, and the procedure for returning payments that have been made for additionally issued shares[296]			✓

d) Issue of Shares for In-Kind Contributions

If the decision to place shares allows shareholders to pay for additional shares with other securities, or with other assets having monetary value, such a decision must also include the:[297]

- List of assets that can be used to pay for shares; and
- Name of the Independent Appraiser(s) who will be used to determine the market value of the assets.

C. Protecting the Charter Capital

One of the purposes of the charter capital is to provide a minimum guarantee that the company will fulfill its obligations toward creditors. However, this function will only exist in theory if it is not linked to preserving a minimum level of company assets. The Company Law provides that the value of a company's net assets at the end of the second and any subsequent year cannot be lower than the stated

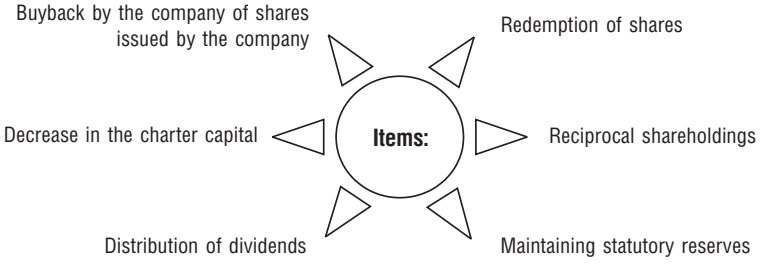
[296] FCSM Regulation No. 03-30/ps, Section 6.1.11. The volume of additionally issued shares that is necessary for the issue to be recognized as having taken place cannot be less than 75% of the additionally issued shares.

[297] FCSM Regulation No. 03-30/ps, Section 6.1.12.

charter capital of the company.[298] Should this occur, the company must decrease its charter capital, but not to a level lower than the minimum amount set forth in legislation.[299] Moreover, the company must liquidate if the value of its net assets at the end of the second year, or any subsequent year thereafter, falls below the minimum amount of the charter capital.[300] This is yet another safeguard for providing protection for creditors. If the company does not make the decision to either decrease the charter capital or liquidate within a reasonable period of time, creditors may request either the early performance, or the early termination of obligations toward them. In both cases, creditors can also request compensation for losses. Finally, state oversight bodies have the right to ask the court to liquidate the company.[301]

There are other actions that may, in one way or another, affect the charter capital and net assets. Such actions and mechanisms, which protect against the distribution of the company's assets to shareholders or other parties to the detriment of creditors, are listed in Figure 1.

Figure 1: Protection the Charter Capital



Source: IFC, August 2003

[298] LJSC, Article 35, Clause 4.

[299] LJSC, Article 29, Clause 1, Paragraph 4. The company cannot decrease its charter capital below the minimum specified by legislation, which is currently set at RUR 100,000 as of 1 January 2004. The minimum charter capital is determined as of the date of submission of the documents for the state registration of charter amendments related to the decrease of the charter capital. However, when the decrease is required by the Company Law, the minimum charter capital must be determined as of the date of the company's state registration.

[300] LJSC, Article 35, Clause 5.

[301] LJSC, Article 35, Clause 6. The Constitutional Court of Russia has recently upheld the legality of these rules (Decision No. 14-P, the Constitutional Court of the Russian Federation, 18 July 2003).

1. Overview of Decreasing the Charter Capital

A decrease in the company's charter capital is generally used as a tool to create returns for shareholders without paying dividends. Decreases in charter capital — more specifically, share buybacks — do however have the potential for abuse. A decrease in the charter capital can favor some shareholders at the expense of others. If a decrease in the charter capital involves a share buyback, it is essential to ensure the equitable treatment of all shareholders. This holds particularly true if the company has several classes of shareholders with different rights or holders of other securities. At the same time, a decrease in the charter capital reduces the level of shareholders' liability and the minimum amount of assets intended to serve as a guarantee that the company will fulfill its obligations toward creditors.

Thus, any decrease in the charter capital can be:

- **Real** when it involves a share buyback from shareholders; or
- **Nominal** when the charter capital is decreased by writing off losses, intended to either reorganize the company's financial position or create reserves that can be used for future distribution.

a) Methods of Decreasing the Charter Capital

The charter capital can be decreased in three different ways as summarized in Table 6.[302]

Table 6: Methods of Decreasing the Charter Capital

	Decrease the Nominal Value of Issued Shares	Retire Treasury Shares	Buyback Outstanding Shares and Retire These
Type of Decrease	Nominal	Nominal	Real
Legal Stipulation	Mandatory and/or voluntary	Mandatory and/or voluntary	Voluntary
Charter Stipulation	Always permitted	Always permitted	Only if permitted by the charter

[302] LJSC, Article 29, Clause 1, Paragraph 2.

Table 6: Methods of Decreasing the Charter Capital			
	Decrease the Nominal Value of Issued Shares	**Retire Treasury Shares**	**Buyback Outstanding Shares and Retire These**
Who Can Propose the Decrease	Shareholders or the Supervisory Board	Shareholders or the Supervisory Board	The Supervisory Board, unless the charter provides otherwise
Approving Governing Body	The GMS	The GMS	The GMS
Class by Class Voting	Yes, if the rights of preferred shareholders can be limited as a result of decreasing the charter capital	No	No
Implementation of the Decrease	Conversion of shares with a higher nominal value into shares with a lower nominal value	Retiring treasury shares	Purchasing and retiring shares

b) Mandatory and Voluntary Decreases of the Charter Capital

A decrease in the charter capital is required by legislation, if:[303]

- At the end of the second and every subsequent financial year the value of the net assets of the company is less than the charter capital; and
- Treasury shares are not replaced within one year after the company has purchased them.

Decreasing the charter capital by retiring treasury shares is only possible if permitted by the charter.[304]

c) Procedures for Decreasing the Charter Capital

Regardless of which method is chosen, the decision to decrease the charter capital must be taken by a simple majority vote of shareholders participating in the GMS.[305]

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[303] LJSC, Article 35, Clause 4; Article 34, Clause 1, Paragraph 5; Article 72, Clause 3, Paragraph 2; Article 76, Clause 6, Paragraph 2.

[304] LJSC, Article 29, Clause 1, Paragraph 3.

[305] LJSC, Article 29, Clause 2; Article 49, Clause 2.

The proposal to decrease the charter capital by decreasing the nominal value of issued shares, or by retiring treasury shares, can be placed on the agenda of the GMS either by shareholder proposal or at the initiative of the Supervisory Board. If shares are repurchased for retirement, the right to put this resolution on the agenda of the GMS rests exclusively with the Supervisory Board, unless the charter provides otherwise.[306]

If the proposal to decrease the charter capital is submitted by the Supervisory Board, a simple majority vote of its members participating in the Supervisory Board meeting is required, unless the charter or by-laws require a higher percentage of votes.[307]

Best Practices: The quorum for the Supervisory Board meeting proposing to decrease the charter capital should be defined as $^2/_3$ of all directors.[308]

d) Information Included in the Decision to Place Shares

To decrease the charter capital by reducing the nominal value of issued shares, new shares with a lower nominal value must be issued, and the existing shares have to be converted into these newly issued shares. In this case, the decision to decrease the charter capital is also called the decision to place shares and must include information on:[309]

- The types and classes of shares, the nominal value of which will be decreased;
- The nominal value of shares for each type and class after the decrease has taken place; and
- The method of placing shares (in this case, the conversion of shares with a higher nominal value into shares with a lower nominal value).

The decision to place shares can also include information on the date, or the procedure to determine such date, when shares must be converted.[310]

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[306] LJSC, Article 49, Clause 3.

[307] LJSC, Article 68, Clause 3.

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

[309] FCSM Regulation No. 03-30/ps, Section 5.1.2.

[310] FCSM Regulation No. 03-30/ps, Section 5.1.2.

e) Decreases in the Charter Capital and Creditor Protection

The decrease of the charter capital typically affects creditor rights since it decreases the minimum amount of the company's assets serving as a guarantee that the company can meet its obligations toward creditors. The company must then notify creditors in writing of a reduction in the charter capital. It must further publish an announcement in the print media that publishes information on the state registration of legal entities regarding the decrease in its charter capital within 30 days after the decision is taken.[311] This falls under the authority of the General Director who will commonly assign this task to the Corporate Secretary or another person.

The company is required to present evidence to the state registration authority of the timely notification of all creditors regarding the decrease in the charter capital before the respective charter amendments can be registered.[312]

Within 30 days after the submission of the notification to creditors, or after the publication of the announcement, a creditor has the right to demand in writing:[313]

- Early termination of the company's obligations and the reimbursement of losses caused by early termination; or
- Early fulfillment of obligations by the company and the reimbursement of losses related to early fulfillment.

2. Share Buybacks

Under certain circumstances and conditions, companies have the right to repurchase their own shares. This is called a share buyback. Share buybacks may have a number of corporate governance implications. First, there may be a financial planning concern: since cash is used to purchase shares, fewer funds may be available for further business development. Second, shareholder rights can be abused if the company does not provide equal opportunity to all shareholders to sell their shares back to the company. Third, the company distributes cash directly to selling shareholders and may therefore diminish the company's ability to service its debts or otherwise meet its obligations to creditors.

[311] LJSC, Article 30, Clause 1.

[312] LJSC, Article 30, Clause 2.

[313] LJSC, Article 30, Clause 1.

Certain rules specify how to conduct a share buyback and are summarized in Table 7. They differ depending on whether the buyback is to decrease the charter capital (specific buyback) or for any other reason (general buyback).

Table 7: Types of Buybacks

Specific[314]	General[315]
The shares issued by the company are repurchased and retired to decrease the charter capital	The shares issued by the company are repurchased for any reason
The repurchase is carried out by decision of the GMS to decrease the charter capital	The purchase is carried out by decision of the GMS, unless the charter delegates this right to the Supervisory Board
The share buyback is only permitted if allowed by the charter	The share buyback is only permitted if allowed by the charter
Shares must be retired upon buyback	Purchased shares must be re-placed or retired within one year

a) Buyback Procedures

To repurchase its own shares, a company must follow steps, as summarized in Table 8.

Table 8: Buyback Procedures

	Specific	General
Initiation	On the basis of the decision to decrease the charter capital	At the discretion of the Supervisory Board or a shareholder proposal
Decision-making	The GMS	The GMS, unless delegated to the Supervisory Board
Purchase price	Market value	Market value
Limitations	The charter capital may not become less than the legal minimum	The nominal value of the outstanding shares must not be less than 90% of the charter capital after the shares have been repurchased[316]

[314] LJSC, Article 72, Clause 1, Paragraph 1.

[315] LJSC, Article 72, Clause 2, Paragraph 1.

[316] LJSC, Article 72, Clause 2, Paragraph 2.

Table 8: Buyback Procedures		
	Specific	**General**
Share retiring	Must be retired upon purchase	Must be retired within one year or re-placed

The decision to buyback shares issued by the company must be approved by either:[317]

- A 3/4-supermajority of shareholders participating in the GMS, upon the proposal of the Supervisory Board, unless the charter provides otherwise; or
- A simple majority vote of directors participating in the Supervisory Board meeting, if the charter delegates this authority to the Supervisory Board.

The Supervisory Board must set the purchase price of shares for each type and class, which is always the market value of shares.[318]

The Supervisory Board must also define the form of payment for the shares. As a rule, a company must pay in cash unless the charter provides otherwise.[319]

In addition, the Supervisory Board must set the period within which the share buyback must take place. This period cannot be less than 30 days.[320]

b) Information Included in the Buyback Decision

The decision to buyback shares must include information on:[321]

- The type and class of shares to be repurchased;
- The number of shares of each type and class;
- The purchase price;
- The form of payment;
- The period for making payments to shareholders; and
- The period within which the buyback will take place.

[317] LJSC, Article 49, Clause 3; Article 49, Clause 4; Article 68, Clause 3.

[318] LJSC, Article 72, Clause 4, Paragraph 2; Article 77.

[319] LJSC, Article 72, Clause 4, Paragraph 2.

[320] LJSC, Article 72, Clause 4, Paragraph 2.

[321] LJSC, Article 72, Clause 4, Paragraph 1.

c) Limitations on Share Buybacks

Several limitations are placed on the repurchase of shares as summarized in Table 9.

Table 9: Limitations on Share Buybacks

The Company Cannot Repurchase if:	Common Shares[322]	Preferred Shares[323]
The nominal value of the outstanding shares will be reduced to less than 90% of the charter capital after repurchase[324]	✓	✓
The charter capital is not fully paid	✓	✓
The company is bankrupt	✓	✓
The company would be bankrupt as the result of a buyback	✓	✓
The company had not redeemed the shares upon the demand of shareholders[325]	✓	✓
The value of the company's net assets is less than the sum of the charter capital, the reserve fund, and the positive difference between the liquidation value of preferred shares of all classes and their nominal value	✓	
The value of the company's net assets will become less than the sum of the charter capital, the reserve fund, and the positive difference between the liquidation value of preferred shares of all classes and their nominal value specified by the charter as a result of the repurchase by the company of common shares	✓	
The value of the company's net assets is less than the sum of the charter capital, the reserve fund, and the positive difference between the liquidation value of preferred shares of a specified class, the owners of which have priority in receiving the liquidation value of their shares in relation to the preferred shares of the specified class that must be purchased by the company, and their nominal value		✓

[322] LJSC, Article 73, Clause 1.

[323] LJSC, Article 73, Clause 2.

[324] LJSC, Article 72, Clause 2, Paragraph 2.

[325] LJSC, Article 73, Clause 3.

Table 9: Limitations on Share Buybacks		
The Company Cannot Repurchase if:	**Common Shares[322]**	**Preferred Shares[323]**
The value of the company's net assets will become less than the sum of the charter capital, the reserve fund, and the positive difference between the liquidation value of preferred shares of a specified class, the owners of which have priority in receiving the liquidation value of their shares in relation to the preferred shares of the specified class that shall be purchased by the company, and their nominal value specified by the charter as the result of the repurchase by the company of preferred shares		✓

d) Implementing a Share Buyback

A company must notify shareholders 30 days before the beginning of the period during which a buyback will take place. The shareholder notification must contain the same information as required for the decision on the buyback.[326]

Any shareholder who owns shares of the type and class that shall be repurchased by the company has the right to sell shares to the company within the specified period. The company must pay for these shares within the period that has been specified in the decision and communicated to shareholders in the notice.[327]

If shareholders offer more shares for sale than the company intends to buy according to the decision on the repurchase, the company must purchase shares from all shareholders in a number that is proportionate to the number of shares that have been offered by shareholders for sale (see Mini-Case 1).[328]

3. Redemption of Shares

The redemption of issued shares is another transaction that may affect the charter capital, and consequently, the rights of shareholders and creditors. Shares redeemed by a company are commonly retired so as to reduce the charter capital. During a reorganization, repurchased shares must be retired upon re-

[326] LJSC, Article 72, Clause 5.

[327] LJSC provides no statutory period for such payment.

[328] LJSC, Article 72, Clause 4, Paragraph 3.

Mini-Case 1		
Charter capital = RUR 300,000 (10,000 common shares with a nominal value of RUR 30 each).		
The company has decided to purchase 1,000 of its own shares.		
Five shareholders offer to sell 2,000 shares.		
The company must purchase shares in proportion to the shares offered by shareholders for sale.		
Shareholders	Number of shares offered to the company:	Number of shares the company must purchase:
Shareholder 1	400	200
Shareholder 2	200	100
Shareholder 3	600	300
Shareholder 4	300	150
Shareholder 5	500	250
Total:	2.000	1.000

Source: IFC, March 2004

demption.[329] The Company Law provides for certain procedures to protect the rights of creditors; in particular, a company cannot use more than 10% of its net assets to redeem shares.[330] If shareholders request the redemption of shares with a total value of more than 10% of the company's net assets, the company must redeem shares from all shareholders pro rata to the number of shares offered for redemption.

➜ *For more information on redemption rights, see Chapter 7, Section B.6.*

4. Reciprocal Shareholdings

Reciprocal or cross-shareholdings are quite common between different companies and may be set up to establish mutual influence or diversify portfolios. Such shareholding structures between two or more companies often cause governance problems. For example:

- If companies increase their charter capital by means of reciprocal subscriptions to shares, the same initial contribution serves to cause two capital increases;

[329] LJSC, Article 76, Clause 6, Paragraph 1.

[330] LJSC, Article 76, Clause 5.

- When two companies create a reciprocal shareholding by acquiring issued shares of each other, they are causing, at least partially, an indirect distribution or repayment to shareholders whose shares are purchased; or
- Reciprocal shareholdings can decrease the normal influence of independent directors in both companies, and replace the normal control exercised by the shareholders over directors and officers, with a self-controlling system.

Russian legislation, however, does not provide any specific rules regarding reciprocal shareholdings, unless the relationship of dominance and subordination in groups of companies appears.

➜ *For more information on groups of companies, see Part V, Chapter 15.*

D. Statutory Reserves

Protecting the charter capital to safeguard creditor rights is further extended by the requirement and possibility of creating certain additional reserves. As with the charter capital, such reserves only exist in accounting terms.

1. The Reserve Fund

Every company must have a reserve fund.[331] This fund is used to cover (a portion of) the company's losses, and covers the costs of redeeming shares and bonds when company profits are insufficient for such payment. A company may also establish other funds and additional paid-in capital. The decision as to whether and when to use the reserve fund and the additional paid-in capital is made by the Supervisory Board.

The amount of the reserve fund must be specified by the charter, and cannot be less than 5% of the charter capital. Its main purpose is to protect creditors by ensuring that part of the company's assets, in addition to the charter capital, cannot be distributed among shareholders.

The reserve fund must be funded by annual deductions from the company's net profits. The amount of such annual deductions must be specified in the charter, and cannot be less than 5% of its net profits.[332]

[331] LJSC, Article 35, Clause 1, Paragraph 1.

[332] LJSC, Article 35, Clause 1, Paragraph 2

Only if, and to the extent that the company does not have other resources, the reserve fund may be used to:[333]

- Write off/cover losses of the company;
- Redeem bonds; and/or
- Redeem shares from shareholders.

The reserve fund may only be used upon a decision by the Supervisory Board.[334] The GMS has no authority in this regard.

2. Other Funds

a) Employees' Fund

The GMS can establish a special fund from its net profits for company employees.[335] The Company Law does not require or define specific requirements for such a fund. Its establishment is therefore optional, and all provisions governing such a fund must be specified in the charter.

This fund can only be used for acquiring shares, provided that such shares are to be transferred to the company's employees. Accordingly, the Company Law provides for one specific source for replenishing the employees' fund: if a company has transferred shares purchased by using the employees' fund to its employees, the funds collected must be re-directed to the employees' fund.[336]

b) Other Funds of a Company

The charter or a decision of the GMS may establish other internal funds, such as for stock option plans or dividend payments. Such internal funds are financed through a deduction from the company's net profits. An example of such funds is the special fund for the payment of dividends on preferred shares.[337] Such funds can only be used upon a decision of the Supervisory Board.[338]

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[333] LJSC, Article 35, Clause 1, Paragraph 3.

[334] LJSC, Article 65, Clause 1, Paragraph 3, Section 12.

[335] LJSC, Article 35, Clause 2, Paragraph 1.

[336] LJSC, Article 35, Clause 2, Paragraph 2.

[337] LJSC, Article 42, Clause 2.

[338] LJSC, Article 65, Clause 1, Paragraph 3, Section 12.

3. Additional Paid-In Capital

Additional paid-in capital is part of the company's equity and is typically composed of the following sources:

- Any increase resulting from the re-valuation of non-current assets; and
- The positive difference between the nominal value and the placement value of the company's shares.

Additional paid-in capital has an accounting meaning only, and there is no actual accumulation of funds. Additional paid-in capital can be used, for example, to:

- Offset the losses as the result of re-valuating non-current assets; and
- Increase the charter capital from internal resources of the company.

Chapter 10

Dividends

Table of Contents

The Chairman's Checklist

- ✓ Has the Supervisory Board developed a dividend policy? What are the primary issues addressed in this policy?
- ✓ Does the Supervisory Board properly weigh using net profits for the payment of dividends versus re-investing these profits?
- ✓ Does the Supervisory Board properly communicate its dividend policy to shareholders and potential investors, and, if it deviates from this policy, the reasons for doing so?
- ✓ Does the company properly disclose information about its dividend policy and dividend history in a timely manner?
- ✓ Does the Supervisory Board propose intermediary dividends? How does the Supervisory Board ensure that this is done in the best interests of the company?
- ✓ How does the company calculate its dividends? Does the Supervisory Board ensure that preferred and common shareholders are treated equitably when distributing dividends?
- ✓ Does the Supervisory Board ensure that creditor rights are protected when it declares and pays dividends to shareholders?

Successful companies produce profits that can either be retained in the company or distributed to shareholders as dividends. In Russia, there is an expectation, in particular among minority shareholders with small holdings, for companies to make (a reasonable amount of) dividend payments, and not exclusively retain its earnings. The vast majority of Russian companies need additional capital, for which there is no immediately alternate source other than company earnings. Since internally generated financing is one of the few viable sources of funding, the decision to pay dividends is often difficult for Russian companies.

This chapter discusses dividends from both the shareholder and creditor protection perspectives, the procedure for declaring and paying dividends, as well as a company's dividend policy.

A. General Provisions on Dividends

1. The Definition of Dividends

Shareholders have a right to share in the profits of the company. They may do so by enjoying capital gains (an increase in the market value of shares they hold in the company) and/or through receiving dividend payments. From this perspective, dividends are an important shareholder right.

In addition, the payment of dividends means paying out cash to shareholders, which may decrease the company's cash and assets needed to service debt on a timely basis. From this vantage point, dividends are also viewed in light of preserving creditor rights by following certain rules. To protect creditor rights, legislation imposes certain limitations on the types and payment of dividends.

2. Distributable Profit

The accounting treatment of dividend payments is determined both by the Company Law and accounting standards. Dividends can only be paid out of the net profits of the company.[339] Dividends on preferred shares can, however, be paid out of funds that are specifically established for that purpose. Under no circumstances can dividends be paid out of the charter capital.

3. Dividend Rights

Owners of common and preferred shares have different dividend rights. Distributing dividends on common shares is solely at the discretion of the company.[340] On the other hand, owners of preferred shares have a right to dividend payments.

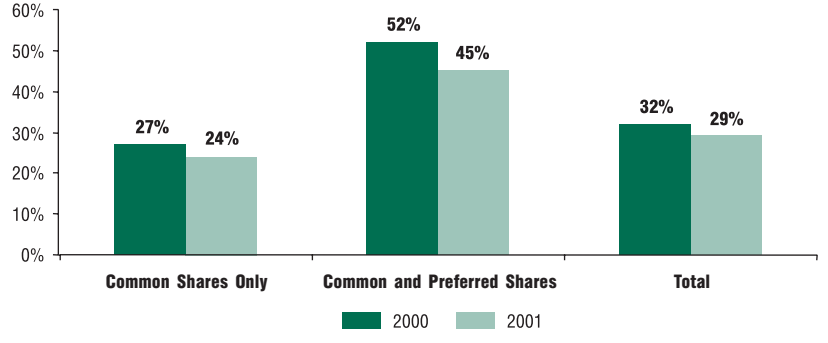
[339] Law on Joint Stock Companies (LJSC), Article 42, Clause 2.

[340] LJSC, Article 31, Clause 2.

If the company does not declare dividends, or declares only a partial payment of dividends to owners of preferred shares, these shares are automatically granted voting rights.

Company Practices in Russia: Figure 1 indicates that companies experience considerable difficulties in making dividend payments on both common and preferred shares in Russia's regions.[341] Only 45% of companies with preferred shareholders paid dividends in 2001, a decrease of more than 7% in comparison with 2000. The percentage of companies with common shares only that paid dividends decreased slightly from 27% in 2000 to 24% in 2001.

Figure 1: Percentage of Companies that Paid Dividends



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

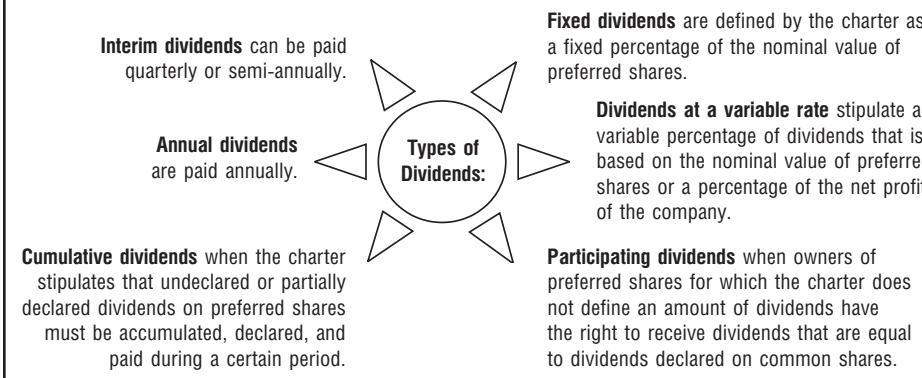
4. Types of Dividends

A company may declare dividends for common and preferred shares as shown in Figure 2.[342]

[341] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.3.2, page 36, August 2003 (see www.ifc.org/rcgp).

[342] LJSC, Article 32, Clause 2, Paragraphs 1 and 3.

Figure 2: Types of Dividends



Source: IFC, March 2004

5. Forms of Dividend Payments

As a rule, dividends are paid in cash, though the charter may allow other forms of payment.[343]

Best Practices: Companies should pay dividends in cash, since non-cash transactions are generally unsuited for dividend payments.[344]

6. Decision-Making Authority Regarding Dividends

The Supervisory Board has the authority to recommend the amount of dividends to pay out to the General Meeting of Shareholders (GMS). The authority to approve dividends, however, rests with the GMS. The GMS approves or disapproves the Supervisory Board's recommendation by a simple majority vote of participating shareholders.[345] The amount of dividends declared by the GMS may not exceed that recommended by the Supervisory Board.[346]

[343] LJSC, Article 42, Clause 1, Paragraph 2.

[344] Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), Chapter 9, Section 2.1.1.

[345] LJSC, Article 42, Clause 3; Article 49, Clause 2.

[346] LJSC, Article 42, Clause 3.

The following rules apply to the payment of dividends on preferred shares:

- If the amount of dividends on preferred shares is less than that required by the charter, the owners of preferred shares receive voting rights;
- Dividends on preferred shares may not exceed the amount specified in the charter; and
- If the amount of dividends on preferred shares is not specified in the charter, the amount of dividends is the same as that paid on common shares.

7. The Amount of Dividends

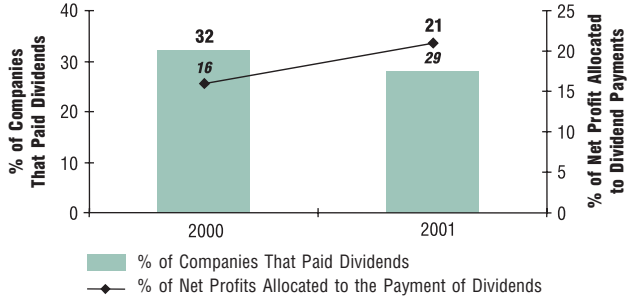
The Supervisory Board should seek to maximize shareholder value when formulating its recommendation on the amount of dividends to be distributed. The target payout ratio — defined as the percentage of net income to be paid out as cash dividends — should be based on shareholder preferences. More specifically, the Supervisory Board will want to determine shareholder preferences for capital gains (for example, using excess cash to buyback shares or re-invest in the company) *versus* receiving dividends. The Supervisory Board will then need to define its optimal dividend policy, which ideally should strike a balance between current dividends and future growth. For any given company, the optimal payout ratio is determined by four factors:

1. Investor preference for capital gains *versus* dividends;
2. The company's investment opportunities (for example, companies with excess cash but limited investment opportunities would typically distribute a large percentage of their income to shareholders via dividends, while companies in high-growth sectors typically reinvest their earnings in the business);
3. The company's target capital structure; and
4. The availability and cost of external capital.

Company Practices in Russia: The results of a 2003 IFC Survey[347] show a slight decline in dividend payments among companies in Russia's regions between 2000 and 2001. This decrease occurred mainly among companies with over 300 employees. In contrast, the percentage of companies paying dividends with less than 300 employees has remained stable. Although fewer companies paid dividends, the percentage of net profits allocated to dividend payment increased from an average of 16% in 2000, to 21% in 2001 (see Figure 3).

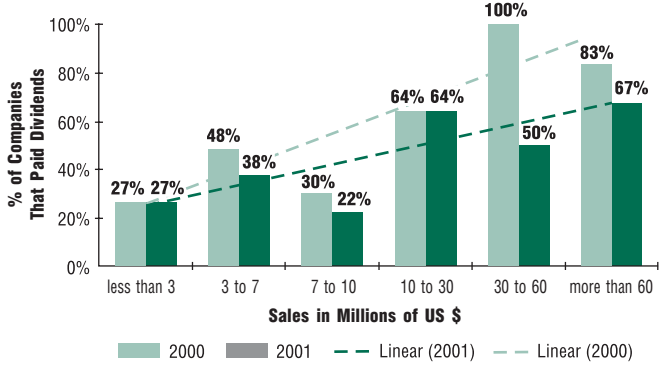
[347] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.3.2, page 36, August 2003 (see www.ifc.org/rcgp).

Figure 3: Percentage of Companies that Paid Dividends and an Average Percentage of Net Profits Allocated to Dividend Payments



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

Figure 4: Correlation Between the Percentage of Companies in Russia's Regions that Paid Dividends and Company Sales



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

8. The Importance of Receiving Stable Dividends

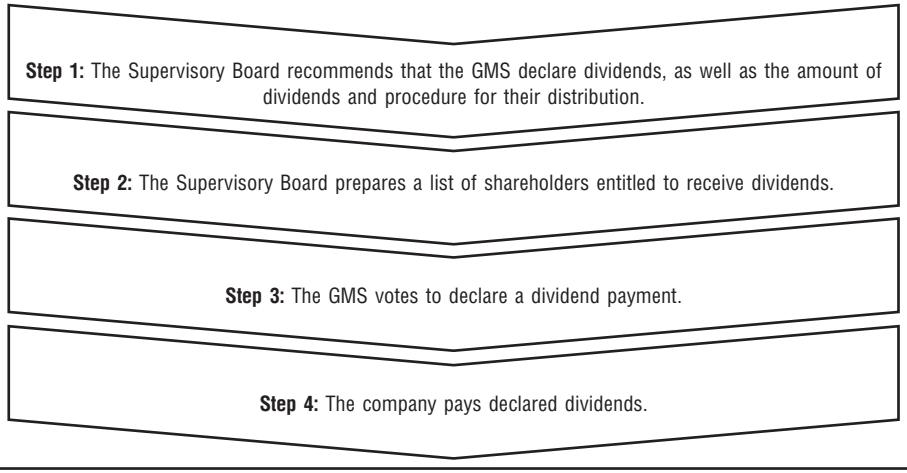
The stability of dividends is important to shareholders. Dividend payments tend to vary over time, since company cash flows may fluctuate. Many shareholders rely on dividends to meet expenses, however, and would consequently suffer from unstable dividend streams. A company needs to carefully balance between the stability and dependability of its dividend policy.

Best Practices: Ideally, the company should formulate and communicate a dividend policy to its shareholders, for example to "pay approximately 30% of its current year's earnings as dividends, which will permit the company to retain sufficient capital to provide for future growth."

B. Procedures for Declaring and Paying Dividends

To declare and pay dividends, the company must follow specific steps, summarized in Figure 5.

Figure 5: The Procedure for Declaring and Paying Dividends



Source: IFC, March 2004

1. How Dividends Are Declared

A company may declare dividends annually, or more frequently if stipulated in its charter.[348] The decision to declare interim dividends, based on quarterly results,

[348] LJSC, Article 42, Clause 1, Paragraph 1. The text of this provision contains the phrase "unless the law provides otherwise" which refers to circumstances when the company cannot declare dividends that are specified by LJSC, Article 43.

must be made within three months of the end of the dividend period.[349] The decision to declare annual dividends is based on the decision regarding the distribution of profits (losses) of the company and can be taken by a simple majority vote of shareholders participating in the GMS.[350]

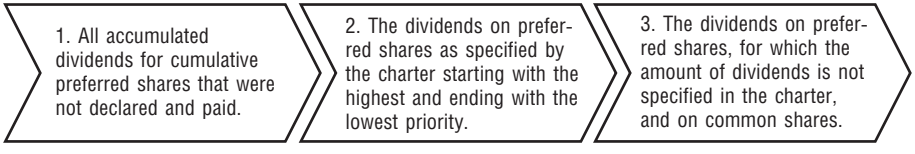
Best Practices: In order to help shareholders properly assess a company's capacity to make dividend payments, companies are advised to:[351]

- Establish a transparent and shareholder-friendly mechanism for evaluating the payment of dividends;
- Provide sufficient information to shareholders to enable them to understand the conditions that must be met before the company will pay dividends;
- Provide sufficient information to shareholders to enable them to understand the procedures for the payment of dividends;
- Prevent the dissemination of any misleading information on the company that might influence shareholders' assessment of policies governing dividend payments;
- Provide simple dividend payment procedures; and
- Impose (financial) sanctions on the General Director and Executive Board members for incomplete or delayed payments of declared dividends.

Dividend reports are a useful tool for assessing a company's dividend policy and its dividend payment record. Dividend reports are published by commercial firms that track the dividend performance of companies. These reports are usually available for a fee.

The Company Law also stipulates a certain sequence for declaring dividends when the company has issued shares of different types and classes as illustrated in Figure 6.

Figure 6: Order of Declaring and Paying Dividends



Source: IFC, March 2004

[349] LJSC, Article 42, Clause 1, Paragraph 1.

[350] LJSC, Article 48, Clause 1, Section 11; Article 49, Clause 2.

[351] FCSM Code, Chapter 1, Section 1.3.

In other words, until the company has declared and paid all dividends (including accumulated dividends) for preferred shares in full, as specified by the charter, it cannot declare and pay dividends for other preferred or common shares.[352] Further, the company cannot declare dividends if the claims of a higher priority shareholder are not satisfied in full.[353]

Company Practices in Russia: The Company Law is not clear as to whether the distribution of annual dividends must be a separate agenda item of the Annual General Meeting of Shareholders (AGM) or a part of the decision on the distribution of profits (and losses). Russian companies commonly treat these decisions separately. However, there is a risk of making conflicting decisions on the amount of dividends as part of the decision on dividend payments and the decision on the distribution of profits. As long as shareholders agree with the recommendation of the Supervisory Board on the amount of dividends, there should be no conflict. However, voting on the dividend payment as part of the more general decision on the distribution of profits appears to be a safer solution. Interim dividends do not present a problem as there is no requirement for approving the distribution of interim profits.

2. The Shareholder List for Dividends

The list of shareholders entitled to receive dividends for a specific period includes shareholders of record entitled to participate in the GMS.[354] This date upon which such record is to be compiled is called the "ex-dividend date". Shareholders included on this list as of the ex-dividend date are entitled to receive any dividends that the company pays out to shareholders. Consequently, shareholders who own shares on the ex-dividend date, and who sell them after that date, retain the right to receive dividends; shareholders who purchased shares after the ex-dividend date are not entitled to receive dividends until the next declaration of dividends. However, the contract of sale for the shares may provide that the right to receive declared dividends shall be transferred to the new owner of shares.

[352] LJSC, Article 43, Clause 2.

[353] LJSC, Article 43, Clause 3.

[354] LJSC, Article 42, Clause 4, Paragraph 2.

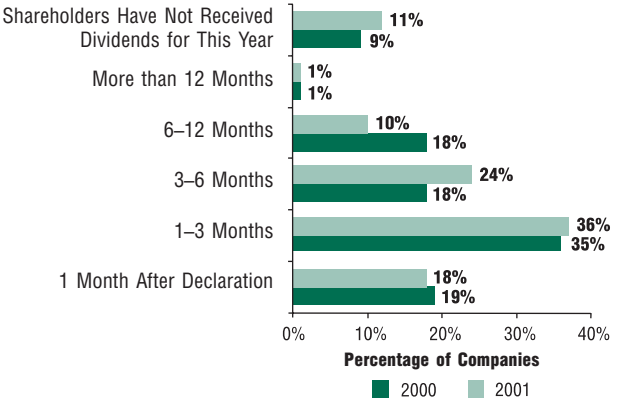
In the event that dividends on shares of a specified type and class are declared, each shareholder must receive dividends in accordance with the number of shares of the type and class he owns.

3. When Declared Dividends Are Paid

A company is obliged to pay dividends once they have been declared.[355] The period for paying dividends is established either in the charter or by decision of the GMS. If not specified, companies must pay dividends no later than 60 days after they are declared.[356]

Company Practices in Russia: The results of a 2003 IFC survey show that arrears on dividend payments are an enormous problem among Russian companies (see Figure 7). According to the Company Law, and as recommended by the Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), companies are required to pay declared dividends within 60 days. However, in 2001, only 18% of companies paid dividends within one month after their declaration, and only 36% paid within three months.[357]

Figure 7: Timeliness of Dividend Payments



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

[355] LJSC, Article 42, Clause 1.

[356] LJSC, Article 42, Clause 4, Paragraph 1.

[357] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.3.2, page 36, August 2003 (see www.ifc.org/rcgp).

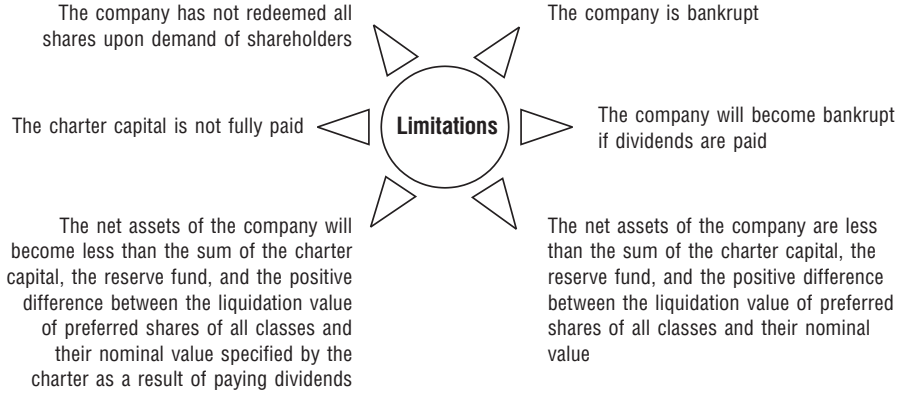
The accumulation of declared but unpaid dividends gives shareholders the right to file a claim in court against the company demanding payment.

Best Practices: The FCSM Code recommends that companies penalize the General Director, Executive Board members, or the External Manager when dividend payments are incomplete or in arrears. In particular, it is recommended that the Supervisory Board have the authority to reduce the remuneration of the General Director, Executive Board members, and/or the External Manager, or to terminate their authorities, when the company fails to pay declared dividends in full and/or on time.[358]

4. When the Company Cannot Declare Dividends

The company is prohibited from declaring dividends under the circumstances illustrated in Figure 8.[359]

Figure 8: When the Company Cannot Declare Dividends



Source: IFC, March 2004

[358] FCSM Code, Chapter 9, Section 3.

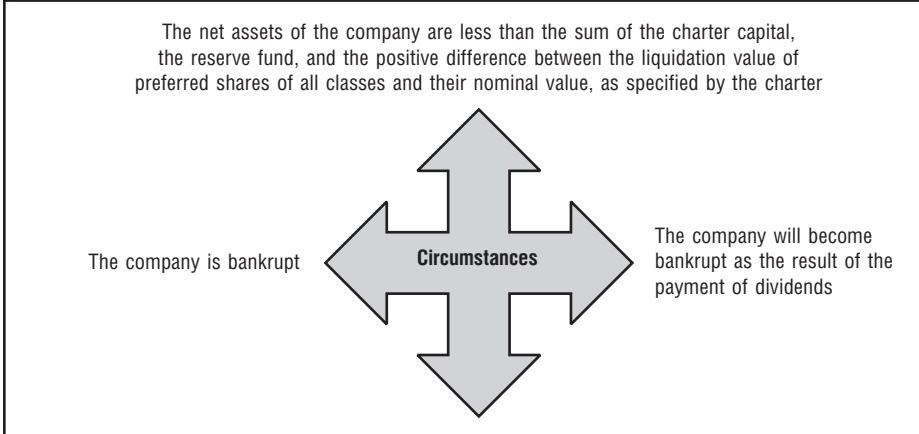
[359] LJSC, Article 43, Clause 1.

This list of circumstances is not exhaustive. The Company Law stipulates that legislation may specify further circumstances under which the company cannot declare dividends. In addition, both the charter and the company's debt instruments can specify circumstances under which the company is prohibited from declaring dividends.

5. When the Company Cannot Pay Declared Dividends

As some time may pass between the decision to declare dividends and the actual payment, the company may find itself in contravention of some of the requirements for the declaration of dividends noted above. The company may not pay declared dividends under the circumstances illustrated in Figure 9.[360]

Figure 9: When the Company Cannot Pay Declared Dividends



Source: IFC, March 2004

[360] LJSC, Article 43, Clause 4, Paragraph 1. Note that a court decision declaring the company bankrupt is not required; the factual features of the company's bankruptcy suffices to prohibit the payment of dividends.

This list of circumstances is not exhaustive. As mentioned above, legislation may specify further grounds, as can the charter and corporate debt instruments. As soon as the specified conditions cease to exist, the company is obliged to pay declared dividends.[361]

C. The Disclosure of Information on Dividends

Securities legislation regulates the information disclosure as pertaining to dividends. A company must make available to all its shareholders the recommendations of the Supervisory Board regarding the distribution of profits, including the amount of proposed dividends on all types of shares, and the procedure for the payment of such dividends.[362]

A company needs to address two basic issues in deciding to declare dividends:

1) The percentage of profits to be distributed; and
2) The frequency of payments, i.e. should the dividends vary from year to year, or remain stable over time.

A company is also required to provide a report on its dividend payment record in its annual report.[363]

Best Practices: The FCSM Code recommends that the company adopt a by-law on information disclosure, and that this by-law include a list of information, documents, and materials that must be submitted to shareholders to enable them to make decisions regarding dividends. The information should refer to agenda items for the GMS, such as:[364]

- Recommendations of the Supervisory Board regarding the distribution of profits;
- Recommendations of the Supervisory Board on the payment of dividends; and

[361] LJSC, Article 43, Clause 4, Paragraph 2.

[362] FCSM Regulation No. 17/ps on Additional Requirements for the Procedure of Preparing, Calling and Conducting the General Meeting of Shareholders (FCSM Regulation No 17/ps), 31 May 2002, Section 3.2.

[363] FCSM Regulation No. 17/ps, Section 3.6.

[364] FCSM Code, Chapter 7, Section 3.2.1.

- Reasons for each recommendation.

Companies should also disclose information on dividend payments, or when dividends have not been paid, the reasons for dividend non-payment.[365]

Companies are required to include the following information on dividends in the prospectus and quarterly reports:[366]

- The amount of dividends declared within the last five years or, if the company has been in operation for less than five years, during each year of operation; and
- The procedure for dividend payment.

D. Dividend Policy

Companies are best served by adopting a clearly stated and rational dividend policy, in-line with shareholder preferences.

Best Practices: Companies should inform the markets of their dividend policy, for example, through the print media. This disclosure should be in the same publication specified by the charter for publishing notice for the GMS. The company should also consider using the internet for this purpose.[367]
It is essential that shareholders receive information — at a very minimum — on the following issues:[368]

- The method the company uses in determining the portion of profits that may be paid as dividends;
- The conditions under which dividends may be paid;
- The minimum amount of dividends payable for shares of each type and class;

[365] FCSM Code, Chapter 7, Section 3.3.2.

[366] FCSM Regulation No. 03-32/ps on the Disclosure of Information by Security Issuers, 2 July 2003, Annexes 4 and 11.

[367] FCSM Code, Chapter 9, Section 1.1.3.

[368] FCSM Code, Chapter 7, Section 2.1.3.

- The criteria the Supervisory Board uses in deciding on the recommendation to declare dividends; and
- The procedure for dividend payment, including the time, place, and form of payment.

Companies should further implement a transparent and easy-to-understand mechanism for determining dividends. To do so, the company should approve a by-law on dividends that includes information on:[369]

- The percentage of net profits for dividend payments;
- The terms and conditions for dividend payments;
- The amount of dividends payable for shares of a specific type and class if this amount is not specified by the charter;
- The minimum amount of dividends payable for shares of each type and class;
- The procedure for the payment of dividends, including the schedule, place, and methods; and
- Circumstances when dividends will not be declared, or when dividends may be partially declared on preferred shares.

Companies are free to change their dividend policies at any time; however, corporate officers should be aware that this may cause inconveniences for their shareholders and send adverse, if unintended, signals to the markets.

[369] FCSM Code, Chapter 9, Section 1.1.2.

Chapter 11

Corporate Governance **Implications** of **Corporate Securities**

Table of Contents

The Chairman's Checklist

- ✓ When was the last time the company rigorously examined its financial needs?
- ✓ If the company is in need of external financing, what are the alternative sources? What are the advantages and disadvantages of debt *versus* equity financing? What are the costs? What is the company's optimal debt-to-equity ratio? What are the corporate governance implications of each of the alternatives?
- ✓ What is the most appropriate financing method for the company, and why?
- ✓ Has the company explored international financing options?
- ✓ What are the advantages and disadvantages of accessing capital in foreign markets? What are the corporate governance implications of listing on foreign exchanges?
- ✓ What are the disadvantages and advantages of stock options?

Companies have a number of financing options. They may fund their investment needs from internally generated capital or seek external financing. Among external sources of funding, they may borrow from banks or issue securities.

Financing decisions are usually quite complex. The method(s) that a company chooses to finance its operations will depend upon a large number of internal and external factors. Some of the company specific factors include the intended use of the funds (whether for short-term working capital needs or long-term capital investment), the capacity to service interest payments and repay principal, and the nature (and the degree of risk) of the business. Important external factors include the level of a country's economic development, political stability, its banking system, and financial markets.

Each financing option (whether bank lending or the sale of equities or bonds) has different financial and legal characteristics and will have different corporate governance implications. In addition, each form of capital has a different cost. Equity finance has some important differences and advantages for companies. Although it is not the cheapest source of funding, equity finance has the advantage of permitting companies to access large amounts of capital that do not need to be paid back in the same manner as debt financing.

However, access to the enormous potential of securities markets — with its millions of potential investors — comes at a price. Securities markets are traditionally tightly regulated to limit the manifest potential for abuse. Regulators therefore make significant demands on companies. They require that investors receive complete information on the risks of investment; and they also go to great lengths to protect investor rights. While market regulators are often criticized for the burdens they impose on companies, real and potential abuses are, ultimately, the reason for the imposition of regulation and of corporate governance standards.

This chapter discusses the different types of securities that companies may issue and their corporate governance implications.

A. An Overview of Corporate Securities

1. Equities and Bonds

There are two basic types of securities that companies use to raise capital: 1) equities (also referred to as stocks or shares); and 2) corporate bonds. Equities represent an ownership position in the company and come with certain ownership rights. Bonds, on the other hand, represent a creditor relationship with the company. Unlike shareholders, bondholders have no corporate ownership rights, although they may be accorded a significant degree of control over (certain) corporate activities during the life of the creditor/debtor relationship.

Bonds envisage the repayment of the principal as well as periodic interest payment until the bond reaches maturity and the obligation of the borrower (the company) to make any further payments of principal/interest is terminated. Corporate bonds come in many different forms and may be structured in a number of ways. For example, there is no provision for interest payments on "zero coupon" bonds. The bondholder in such a case is compensated by a discounted purchase price and the gradual appreciation in the price of the bond, which is then redeemed at its face value on its maturity date. Despite the many differences, bonds have one element in common in that they come with a predictable and contractually fixed repayment.

Equities function differently. Companies can use equity capital for an unlimited period and are under no immediate obligation to repay investors. Investors are compensated for their investment either through the possibility of receiving capital gains (an increase in the value of their shares) and/or the possibility of receiving dividend payments in addition to governance rights. From an investor point of view, equities — as an investment class — are normally riskier than bonds. Capital gains are never guaranteed (share prices go up and down) and companies are not obligated to make any dividend payments to holders of common shares.

An important implication of the difference in risk is that equity capital is often more expensive than bonds or bank lending. One of the most fundamental rules of finance is: the higher the level of risk, the greater the level of return that investors will expect (demand) for taking such risk. Given — as mentioned — that the risk of receiving a return on one's investment is higher for equities than for bonds or other types of loan transactions, investors will demand a higher price for the use of their capital by the company and will charge what is referred to as a "risk premium."

One of the methods to manage equity risk is by granting shareholders governance rights (a full set of rights in the case of common shares and a limited set of rights in the case of preferred shares). Another method of managing risk — and, by extension, of reducing the cost of capital — is to ensure that these rights are uniformly respected and adequately protected. This, from a financial perspective, is what helps to define good corporate governance.

Equities and bonds offer different advantages and disadvantages for investors and companies as outlined in Table 1.

Table 1: Comparison of Equities and Bonds		
	Equities	**Bonds**
Duration of investment	Unlimited. The company does not repay the investment. The company is not restricted in how it may invest funds.	Bonds have a maturity date. While bonds differ, the principal is generally repaid with interest. Repayment is predictable and regular, which reduces bondholder risks.
Obligations in return for the investment	Investors may expect dividend payments when the company generates sufficient cash flow. However, dividend payments are made at the discretion of the company.	The company must repay the principal and generally makes coupon payments.
Governance rights	If common shares are issued, the investor is granted governance rights. If preferred shares are issued, the investor holds governance rights only in specific circumstances. Governance rights and their enforcement reduce the equity investment risk.	No governance rights are granted to bondholders.
Ease of securing the investment	The ease of securing equity investment depends on numerous external and internal factors. Ultimately, the attractiveness of a share offering depends on the company's future prospects and its ability to assure investors that good governance and, in particular, investor rights to the company's free cash flow, will be observed. In addition, the company's health, including compliance with good corporate governance practices, influences the price it pays for equity capital.	Bonds are attractive to investors interested in predictable, secure returns. The company's health, including compliance with good corporate governance practices, is important for the credit rating of the company and will influence the price at which it may borrow.
Cost	From the company's perspective, equities can be more expensive than bonds. Investors charge a risk premium for the higher risk associated with equities.	Bonds are less risky, and investors charge a lower risk premium. Bonds are, consequently, less expensive for the company than equities.

Table 1: Comparison of Equities and Bonds		
	Equities	**Bonds**
Advantages	Most investors are compensated through capital gains (the increase in share prices on the equities markets). If the company generates sufficient free cash flow, the shareholder may receive a dividend. The potential long-term returns on equities as an investment class are higher than bonds.	The bondholder receives his principal back with some compensation for the investment, usually in the form of interest. Generally, interest payments are fixed in advance and predictable. If the company defaults, the bond may, under certain circumstances, still be sold on the market at a discount, meaning that the bondholder may not lose the full amount of his investment.
Risks	The higher returns on equities are in exchange for a higher level of risk. Share prices go up and down, at times quite dramatically. Capital gains on shares are uncertain and dividend payments are not guaranteed. If the company becomes insolvent, shareholders are typically last in line to receive compensation. In practice, shareholders may lose the full value of their investment in case of bankruptcy or liquidation.	Once the company has the cash, it may use the money for riskier activities than those foreseen by the bondholder. In this case, the bondholder may have little recourse. In case of default, the bondholder is granted a set of legal mechanisms to enforce his contractual rights, including seeking the insolvency of the company. However, seeking insolvency is not generally in the interest of the bondholder. If the bond is secured, the risk of the bondholder may be minimized.

2. Primary and Derivative Instruments

Shares and bonds can be described as primary securities, i.e. such which directly certify a specified set of rights. Companies can also issue derivative instruments that embody rights dependent on the performance of underlying or primary securities, assets, or other property. Such instruments can, in international practice, relate to both equities and debt securities.

Best Practices: The issuance of derivatives is associated with the existence of mature capital markets. Derivatives are used by companies mainly as a risk-reduction instrument. At the same time, their existence necessitates special regulation to ensure accounting and information transparency.

According to Russian law, options are recognized as the main form of derivatives. Stock options can play an important role in the context of executive remuneration programs and, consequently, may have important corporate governance implications.

➜ *For more information on stock options and executive remuneration, see Part II, Chapter 5, Section G, as well as Section F of this Chapter.*

3. Securities in Paper and Paperless Forms

Securities must be issued in certain forms and comply with legal requirements.[370] Securities may take two main forms: tangible securities issued in paper form and intangible securities (also known as "paperless" or "dematerialized securities").[371] The rights of the holders of tangible securities are embodied in a certificate. The rights of the holders of dematerialized securities are based upon an entry into a bond or shareholder register (similar to an entry in a bank account reflecting the depositor's rights to funds). In Russia, shares may only be issued in paperless form, unless a law provides otherwise,[372] while bonds can take both forms.

4. Domestic and International Markets

Companies may choose to raise capital in domestic as well as international capital markets. In doing so, they may issue shares and bonds directly on foreign exchanges; they may also issue shares indirectly through depositary receipts. Depositary receipts require the registration of the original security in the name of a foreign trust company or, more commonly, a bank. The bank holds the share in

[370] Civil Code (CC), Article 142.

[371] Law on Securities Markets, Article 2. Tangible and intangible securities may be referred to in translations of Russian documents as "documentary" and "non-documentary" securities.

[372] Law on the Securities Market, Article 16, Paragraph 1.

safekeeping and issues receipts against shares. These receipts are referred to as "depositary receipts." This system was developed because investors in the world's largest capital markets discovered it could take several months to have their foreign share purchases registered in their name. The system is also attractive for companies, since it allows them to establish a presence in foreign markets without having to go through the process of a complete issue. The corporate governance implications of this system are that Russian issuers of depositary receipts must comply, to varying degrees, with foreign standards of corporate governance, as well as with those applicable specifically to the Russian market.

➜ *Raising capital in foreign markets is discussed at slightly greater length in Section G of this Chapter.*

B. Types of Securities

1. Shares

Shares (stock or equities) entitle their holder to a set of property and governance rights, and have several fundamental characteristics:

- **Name of the holder:** Shares in Russia can only be issued as registered securities.[373] This means that the identification of their holder is mandatory to exercise shareholder rights, and the shareholder identity is entered in a shareholder register.[374] Registered securities help to make the company's ownership structure more transparent and assist in protecting shareholder rights.

  ➜ *For a discussion on transparent ownership structures, see Part IV, Chapter 13, Section B.3.*

- **Rights of the holder:** Shares may be common or preferred. Rights pertaining to particular shares are specified in the charter[375] and certified by decision of the Supervisory Board.[376]

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[373] Law on Joint Stock Companies (LJSC), Article 25, Clause 2; Law on the Securities Market, Article 2.

[374] Law on the Securities Market, Article 2.

[375] LJSC, Article 27, Clause 1.

[376] Law on the Securities Market, Article 18.

- **Nominal value:** Each share has a nominal value (also referred to as "par value" or "face value").[377] The nominal value of shares is established in the charter and is used to calculate the charter capital.[378] Russian law does not require minimum or maximum nominal values of shares. The nominal value of all common shares issued by the company must be the same.[379]

At the time of its formation, the company must issue shares at a price no lower than their nominal value.[380] The company issues shares after its formation to attract new investors at a price equal to their market value, as long as this value is not lower than their nominal value.[381] Changing the nominal value of shares for the purposes of increasing, decreasing, or restructuring the company's capital must comply with a special procedure.

➜ *For more on shareholder rights in this respect, see Chapter 7, Section B; for more on procedures for increasing, decreasing, or restructuring the charter capital, see Chapter 9.*

The nominal value of shares rarely reflects the true value of the company. The differences between the nominal value of shares and the price at which they trade on the market can be enormous. In addition, market prices constantly fluctuate.

The value of shares may be determined by the discounted free cash flow that a company generates. The assessment of such cash flow is, in turn, determined by a great number of factors, including the current performance and future prospects of the company, its dividend policy, the reputation of the company and its management, the macroeconomic situation, and government support for (or interference in) business development. The level of demand also affects share prices.

Not least of these factors is the quality of the company's governance. Ultimately, the free cash flow of a company has little value to shareholders unless they can assert their rights.

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[377] LJSC, Article 25, Clause 1.

[378] LJSC, Article 11, Clause 3.

[379] LJSC, Article 25, Clause 1.

[380] LJSC, Article 36, Clause 1.

[381] LJSC, Article 36, Clause 1.

2. Bonds

Bonds are securities through which companies raise debt capital. A bond has the following legal characteristics:

a) Registered and Bearer Bonds

As with shares, bonds can be issued as registered securities.[382] In such cases, the bondholder is identified in a bondholder register, which the company is required to maintain. If the number of bondholders exceeds 500, the register must be maintained by an external organization, which is registered as a professional participant in the securities market.[383]

Unlike shares, however, bonds can also be issued as bearer securities.[384] Bearer bonds have the advantage of privacy for the bondholder. Bearer bonds are issued with certificates, which contain certain legal requirements.[385] If a bearer bond is lost, the rights of its holder can only be affirmed by a court through special procedures.[386] Bearer bonds may facilitate the transfer of bonds and reduce the administrative costs for the company of maintaining a bond register.

Best Practices: Despite these advantages, the use of bearer bonds may result in violations of securities and tax laws. Because they are easy to transfer, owners of bearer bonds may not be as precise about adhering to the laws when they sell bearer bonds to another person as they would need to be in the event of registered bonds. Thus, for example, bearer instruments have the great disadvantage that they may conceal assets from creditors or the tax authorities.

b) Nominal Value

Bonds are issued at a certain nominal value.[387] The nominal value of bonds is most often referred to as their "face value". In the interest of bondholders (and, one could argue, of shareholders as well), the face value of all bonds issued by

[382] LJSC, Article 33, Clause 3, Paragraph 8.

[383] Law on Securities Markets, Article 8, Clause 1.

[384] LJSC, Article 33, Clause 3, Paragraph 8.

[385] Law on Securities Markets, Article 16; Article 18, Article 27.2, Clauses 2 and 3.

[386] LJSC, Article 33, Clause 3, Paragraph 8.

[387] LJSC, Article 33, Clause 3, Paragraph 3.

the company must not exceed: 1) the value of the charter capital, or 2) the value of a guarantee submitted to the company by a third party for the purposes of the bond issue.[388] In any event, bonds may not be issued before the charter capital has been paid in full.

c) Rights of Bondholders

The bondholder has the rights of a creditor, and is entitled to:

- **Redeem the bond at maturity for its face value.**[389] A company can issue bonds with different redemption alternatives. It can issue bonds that have the same payment period or a series of bonds with different payment periods. The company can also envisage the possibility of early payment at the request of the holder;
- **Receive interest payable on the bond.**[390] Interest payments on bonds are generally referred to as coupons. (Historically, bonds were issued with detachable coupons that were submitted in exchange for payment.)

Since bonds are freely transferable, the bondholder can sell his bond to another investor. As with equities, bonds are subject to a market pricing mechanism. This means that bond prices are constantly fluctuating, and that bondholders can both make and lose money from buying and selling bonds.

d) Secured and Unsecured Bonds

Companies may issue both unsecured and secured bonds,[391] although they may not issue unsecured bonds during the first three years of their existence.[392] This rule is intended to protect bondholders from the risks associated with a new business.

Secured bonds provide additional protections to bondholders in case the company defaults on its obligations. The law provides the following guarantees:

- **Pledges of property.** Only securities or "immovable property" can be the subject of the pledge (security).[393] Immovable property includes land, or a building together with any machinery, plant, furniture, or fittings that are

[388] LJSC, Article 33, Clause 3, Paragraph 3.

[389] LJSC, Article 33, Clause 3, Paragraph 4; Law on the Securities Market, Article 2.

[390] LJSC, Article 33, Clause 3, Paragraph 1; Law on the Securities Market, Article 2.

[391] LJSC, Article 33, Clause 3, Paragraph 6.

[392] CC, Article 102, Clause 2; LJSC, Article 33, Clause 3.

[393] Law on the Securities Market, Article 27.3, Clause 1.

fixed to the property. It may also include rights with respect to land or a building. Immovable property is subject to a valuation of an Independent Appraiser. All secured bondholders of the same issue have equal rights with regard to the pledged property.

- **A third party guarantee** can be submitted to the company for the purposes of the bond issue. This can be a bank guarantee or a corporate (for example, submitted by a parent company for bonds issued by a subsidiary) or personal guarantee. The guarantor is jointly and severally liable for the redemption of the bond. In case of a bank guarantee, the law prohibits the revocation of the guarantee.[394] It requires that the period of validity of the guarantee be at least six months longer than the bond redemption date.

The issue of secured bonds means that guarantee requirements must be fulfilled (pledges, mortgages, or bank guarantees, as well as the notarization and the state registration of a mortgage) in addition to the normal requirements associated with a bond issue.[395]

In principle, the redemption of bonds is protected by the requirement in the Company Law for the company to maintain a reserve fund that can be used, among other things, for the redemption of bonds.[396]

➜ *For more information on reserve funds, see Chapter 9, Section D.1.*

e) Convertible Bonds

Companies can also issue bonds that can be converted into shares.[397] In international practice, convertible bonds may: 1) grant bondholders the right to subscribe for shares at a later date and specified price (also referred to as "subscription warrants", or "warrants" for short); 2) be directly convertible into shares; or 3) be reimbursable by shares.

In any case, the Company Law requires that the conversion of bonds be authorized by the charter. A company cannot issue bonds if the amount of the authorized shares is insufficient to allow for the conversion of bonds.[398]

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394 Law on the Securities Market, Article 27.5.

395 Law on the Securities Market, Article 27.3.

396 LJSC, Article 35, Clause 1.

397 LJSC, Article 33, Clause 2, Paragraph 2.

398 LJSC, Article 33, Clause 4.

f) Differences Between Bondholder and Shareholder Interests

Both shareholders and bondholders are interested in the profitability and health of the company. For shareholders, a healthy company generates free cash flows that generally lead to a higher market valuation. Healthy companies are also more likely to pay dividends than unhealthy ones. For bondholders, a healthy company reduces the risk of default on its obligation to repay the bond principal and interest. In short, for both, a successful and profitable company can lead to an increase in the market value of their respective securities.

There are, however, some important differences between the interests of these two types of investors.

- **Interests diverge most distinctly during insolvency.** During insolvency proceedings, different priorities are assigned to different types of claimants. In general, creditor claims (including those of bondholders) are always satisfied before those of shareholders.
- **Another difference is in the conversion of bonds.** Shareholders are always interested in minimizing the dilution of their holdings. It is, in part, for this reason that they enjoy certain governance rights, and that decisions that would result in the dilution of share ownership are always subject to the approval of the company's governing bodies.[399] Similarly, holders of convertible bonds are interested in preventing the reduction of capital or the redemption of shares when this conflicts with the exercise of their conversion rights.
- **The interests of shareholders and bondholders also diverge with respect to risk.** Shareholders generally accept a higher level of risk than bondholders in exchange for potentially higher returns. If a company successfully takes higher risks, returns to shareholders will be higher. If a company fails in its risk-taking, the losses will be greater. Bondholders will, on the other hand, always receive the same contractually stipulated return regardless of the level of risk of the projects that the company undertakes; bondholders only stand to lose if the level of risk to the enterprise ultimately results in corporate insolvency. This holds particularly true for holders of unsecured bonds. Bondholders always hope to see a predictable, stable cash flow, and, if possible, a reduction in the company's risk profile.

[399] Shareholders are not necessarily always opposed to dilution. They may accept some level of dilution as a necessary cost to achieving the goals of the enterprise. A common example is the issue of stock options as part of incentive compensation programs. The cost of share dilution is, arguably, less than the benefits achieved by a highly motivated workforce.

Best Practices: In some countries, company laws incorporate special measures for balancing the conflicting interests of shareholders and bondholders by:

- **Granting bondholders consultation rights.** In France, for example, the meeting of bondholders must be consulted in a number of circumstances, such as the reorganization or issuance of bonds that are secured by significant company assets.
- **Allowing bondholders to inspect documents** during the General Meeting of Shareholders (GMS), as is the case in Germany.
- **Prohibiting the redemption of shares** or reduction of capital while bonds are open for conversion or subscription, for example in France.

Russian law does not provide bondholders with special rights, although nothing prohibits Russian companies from inviting bondholders to the GMS or even to Supervisory Board meetings. As in France, information can also be sent to bondholders on issues that may be of special concern to them. Companies may wish to develop specific policies with respect to bondholders and are encouraged to integrate them into their overall programs on corporate governance.

C. Issuing Securities

Issuing securities is a complex process involving a transfer of funds in exchange for specific control and cash flow rights, all subject to different levels of assurance and guarantee. Efficient capital markets help companies raise capital for productive uses. They also allow investors to reap returns on their capital (that might otherwise lie dormant) and to select investments that correspond to their desired level of risk and return.

Capital markets cannot bring users and providers of capital together efficiently if the markets are subject to misuse. Unfortunately, the history of financial markets both in Russia and throughout the world is rife with such examples. Securities legislation has developed largely in response to abuse and market failure. Its purpose is to protect the interests of companies and investors, and to enhance the function and efficiency of capital markets.[400] Accordingly, the issuance process of all securities in Russia is subject to state registration, during which the Federal

[400] At the same time, market regulators must make sure that they do not strangle entrepreneurial drive or company growth. Companies are wealth generators in every economy, and elaborate regulation usually entails costs. The challenge for regulators is to develop intelligent regulations that meet its goals while imposing the minimum level of costs upon the economy and society.

Commission for the Securities Market (FCSM)[401] uses its powers to ensure the transparency and legality of the issuance.

Legal requirements for issuing equities differ according to the method of placement and, more specifically, according to the type and number of investors involved. These differences are summarized in Table 2.[402]

Table 2: Overview of Share Issue Methods

Method of Placement	Legal Requirements
Closed subscription, if the number of potential investors is less than 500	• The decision to issue securities, and the report on the results thereof, are subject to state registration; and • A prospectus may be registered on a voluntary basis.
Closed subscription, if the number of potential investors is more than 500	• The decision to issue securities, and the report on the results thereof, are subject to state registration; • It is mandatory to prepare and register a prospectus with contents prescribed by law; • A securities market financial consultant may be invited to certify the prospectus;[403] and • Specific information must be disclosed at every step of the issue process.
Open subscription[404]	• The decision to issue securities, and the report on the results thereof are subject to state registration; • It is mandatory to prepare and register a prospectus with contents prescribed by law; • The prospectus must be certified by a securities market financial consultant;[405] and • Specific information must be disclosed at every step of the issue process.

401 In late March 2004 under government reorganization, the FCSM was replaced by the Federal Service for Financial Markets (FSFM). Its authorities are expected to be widened, with additional supervisory authority from the Antimonopoly and Finance Ministries. At the time of publishing this Manual, the authority of the new FSFM had not been finalized.

402 Law on the Securities Market, Article 19, Clause 2.

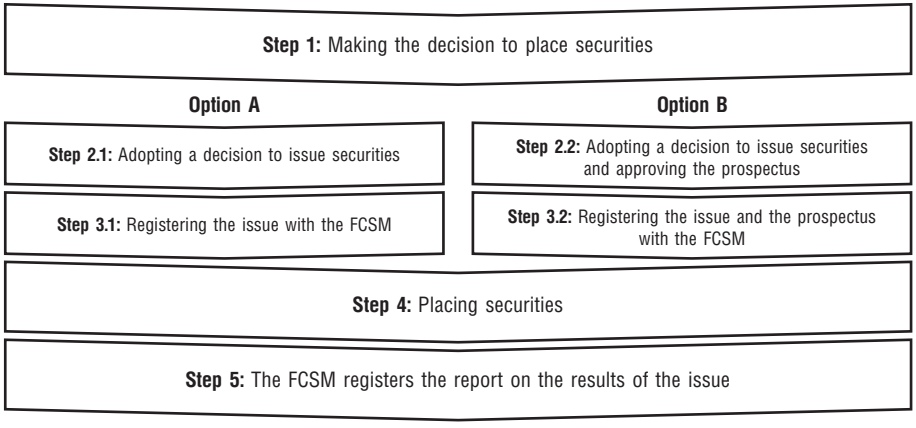
403 According to Article 2 of the Law on the Securities Market, a securities market financial consultant is a legal entity licensed to carry out broker's and/or dealer's activity in the securities market and/or perform services in relation to preparing the securities prospectus of an issuing company. Common usage in English would be "securities market professional."

404 Article 2 of the Law on the Securities Market refers to open subscriptions as "public subscriptions."

405 Law on the Securities Market, Article 22.1, Clause 2.

The process of issuing securities involves a number of steps, as illustrated in Figure 1.[406] Option A illustrates the procedure when a prospectus is not required and Option B when it is required.

Figure 1: Securities Issue Procedure



Source: IFC, March 2004

The following section discusses the above-mentioned steps in greater detail and highlights the differences between equities and bonds.

1. Making the Decision to Place Securities

The decision to place securities is made by different governing bodies, depending on the type of issue and the charter requirements, as summarized in Table 3.

[406] Law on the Securities Market, Article 19, Clause 1; FCSM Regulation No. 03-30/ps on the Standards of Security Issue and Registration of Security Prospectuses (FCSM Regulation No. 03-30/ps), 18 June 2003, Section 2.1.1.

Table 3: The Decision to Place Different Types of Securities	
Shares	The GMS generally approves the decision. ➜ *For more information on the decision to place shares, see Chapter 9, Section B.2.*
Convertible bonds (or options)	The GMS (or the Supervisory Board, if specified in the charter) approves the decision.[407]
Bonds	The Supervisory Board approves the decision, unless otherwise provided for by the charter.[408] The decision-making procedure for issuing bonds may be simpler than for other securities, which may serve as an additional incentive for their use. However, the charter can provide for stricter approval requirements, for example, with regard to specific types of bonds.

2. Adopting the Decision to Issue Securities

The decision to issue securities is made by the Supervisory Board[409] based on, and in compliance with, the decision to place them.[410] This decision must then be adopted within six months.[411] This requirement is important, in as much as the decision to issue securities becomes the main document certifying the rights of the holders of securities and of the company.[412]

Although the contents of the decision depend on the circumstances of each issue, it must generally include information on the:[413]

- Issuing company, i.e. full name, place of business, and postal address;
- Decision to place securities, i.e. date and the decision-making body;
- Decision to issue securities, i.e. date and the decision-making body;

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

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

[409] Law on the Securities Market, Article 17, Clause 2.

[410] FCSM Regulation No. 03-30/ps, Section 2.3.1.

[411] FCSM Regulation No. 03-30/ps, Section 2.3.3.

[412] Law on the Securities Market, Article 18.

[413] Law on the Securities Market, Article 17, Clause 1; FCSM Regulation No. 03-30/ps, Section 2.3.4.

- Securities to be issued, i.e. type and class, their nominal value, the rights of the holders of securities, and number to be issued; and
- Conditions of the placement.

In the case of bonds, the decision must include information on the:[414]

- Form of bond redemption (monetary or in-kind);
- Maturity date (and details regarding early redemption, where applicable);
- Other terms of redemption, i.e. the value of the payment, if early redemption is possible;
- If convertible bonds are issued, the procedure for their conversion into shares;[415]
- If secured bonds are issued, information on the security or the person submitting the guarantee and the conditions of the guarantee (in the latter case, the decision must also be signed by the guarantor);[416] and
- If registered bonds or bonds in paper form are issued with mandatory centralized storage, the date of record for compiling the bondholders list. This date may not be earlier than 14 days before the maturity date. Payments are made to the bondholders of record even if the bond has been transferred to another bearer after the record date.[417]

Copies of the decision to issue securities are kept with the registration authority, the company, and, when the shareholder register is maintained externally, by the External Registrar.[418]

3. Approving the Prospectus

The prospectus is a document through which investors obtain information about securities, including the risks and returns associated with the investment. For this reason, legislation requires that a prospectus be prepared in the case of: 1) any open subscription; and 2) a closed subscription to more than 500 investors.[419]

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414 LJSC, Article 33, Clause 3.

415 LJSC, Article 37, Clause 1.

416 Law on the Securities Market, Article 17, Clause 2; Article 27.2, Clause 2.

417 Law on the Securities Market, Article 17, Clause 2.

418 Law on the Securities Market, Article 17, Clause 4; FCSM Regulation No. 03-30/ps, Section 2.3.5.

419 Law on the Securities Market, Article 19, Clause 2.

Best Practices: Even if a registered prospectus is not required for the issue, companies can still register one voluntarily after filing the report on the results of the securities issue.[420]

There are costs attached to the preparation of a prospectus that some companies may wish to avoid. However, the short-term costs of preparing the prospectus are likely to be greatly outweighed by the long-term benefits (e.g. lower cost of capital) that can be achieved by clarifying the risks and returns of the company to investors.

Investor interests are protected by the information that must be included in the prospectus, the liability attached to those who have signed it, and the requirement for its state registration.

a) The Contents of the Prospectus

Securities legislation contains detailed provisions outlining what must be disclosed in the prospectus.[421] These provisions are summarized briefly below:

1) Information about members of the company's governing bodies, the bank accounts of the company, the bodies controlling its financial and economic activities, the External Auditor, the Independent Appraiser, and other persons signing the prospectus;
2) Information on the terms and procedures for the issue of securities, including information on the volume, terms, and procedures;
3) Essential information about the financial health of the company, including risk factors;
4) Detailed information on the issuing company;
5) Information on the financial and economic activities of the issuing company;
6) Detailed information about the members of the governing bodies of the issuing company, and the bodies controlling its financial and economic activities; and
7) Information on the company's shareholders, related parties, and related party transactions.

[420] Law on the Securities Market, Article 19, Clause 3; FCSM Regulation No. 03-30/ps, Section 10.1.

[421] Law on the Securities Market, Article 22.

Additional information must be included in the prospectus when bonds are issued. For example, the prospectus must include information on the guarantor, and conditions of the guarantee, and be signed by the guarantor when secured bonds are issued.[422]

Best Practices: It is good practice to disclose all material information about the company in the prospectus.[423] The company should seek to provide shareholders and potential investors with all information that may be important in valuing the company.

b) Prospectus Approval and Certification

The Supervisory Board must approve the prospectus.[424] The following individuals must sign the prospectus to certify the truthfulness and completeness of the information included therein:[425]

- The General Director and the Chief Accountant (or the person fulfilling this function);
- The External Auditor;
- The Independent Appraiser in circumstances envisaged by the FCSM; and
- The (securities market) financial consultant in the case of a public offering, except with regard to information already certified by the External Auditor and/or the Independent Appraiser.

The most important feature of this requirement is the liability of those who have signed the prospectus. They are jointly and severally liable with the issuer for any damage caused to investors because of untruthful, incomplete, and/or misleading information.[426] If investors believe that they have suffered damages, they can file claims with a court within three years after the issue. If there is no mandatory requirement for the registration of the prospectus, this period begins with the public trading of securities.

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[422] Law on the Securities Market, Article 22.1, Clause 1; Article 27.2, Clauses 2 and 3.

[423] FCSM Code, Chapter 7, Section 2.1.

[424] Law on the Securities Market, Article 22.1, Clause 2.

[425] Law on the Securities Market, Article 22, Clause 2.

[426] Law on the Securities Market, Article 22.1, Clause 3.

c) Disclosure

When state registration of the issue includes the registration of a prospectus, every stage of the issue process is accompanied by public disclosure.[427]

➜ *For more on information disclosure and the prospectus, see Chapter 13, Section C.1.*

4. The Control over Securities Issue

Registering of the issue and prospectus is an important investor protection mechanism. This is a form of state control over the securities issue process. Without proper registration, securities cannot be considered issued and sold to investors. The FCSM has the power to verify that the legal requirements of the issue have been satisfied (e.g. that the charter capital has been paid in full, or options are issued for no more than 5% of issued shares).[428] It also is charged with verifying the completeness of the information disclosed and taking actions to guarantee its truthfulness. Securities legislation:

- Ensures the quality and availability of information to users;
- Encourages the timely registration of the issue, which is essential for business operations;
- Allows companies to remedy minor defects and thus postpone registration refusal; and
- Guarantees companies the right to appeal if there has been an arbitrary refusal.

For registration purposes, the company is required to submit certain documents required by securities legislation.[429] The FCSM registers the issue and the prospectus and assigns a registration number to the issue.[430] However, there are no provisions in the Law on the Securities Market that allow a claim to be made against the FCSM for the truthfulness of information, even if it conducted an investigation.[431]

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427 Law on the Securities Market, Article 19, Clause 2 and Article 30.

428 Such as the requirements provided in LJSC, Article 33, Clause 3; FCSM Regulation No. 03-30/ps, Sections 2.4.20 and 2.4.21.

429 FCSM Regulation No. 03-30/ps on the Standards of Security Issue and Registration of Security Prospectuses, 18 June 2003, Section 2.4.2.

430 Law on the Securities Market, Article 20, Clause 4.

431 Law on the Securities Market, Article 20, Clause 5.

FCSM control over securities issue procedures extends beyond the registration of the issue and prospectus. If it discovers legal violations after registration, it can request that a court invalidate the issue.[432] The FCSM can deem that the issue was not undertaken in good faith in the case of violation of legal requirements in the process of the issue or discovery of untruthful information in the documents that have served as the basis for the registration.[433]

In such cases, the FCSM can temporarily stay the procedure until defects are remedied. More importantly, the FCSM can invalidate the issue. This can be done within three months from the date of registration of the report on the results of the issue. If an issue is invalidated, securities must be returned to the company and issue proceeds refunded to investors. Figure 2 illustrates the steps required for the state registration of securities issues.

Figure 2: Procedures for the Registration of Securities Issues

Step 1: The FCSM reviews submitted documents.

Step 2: The FCSM makes a decision on the state registration within 30 days of the date when all documents have been received, or conducts an investigation of the truthfulness of the information, included in the prospectus and other required documents, of no longer than 30 days.

Step 3.a: The FCSM grants a registration number to each issue.

Step 3.b: The FCSM can refuse the registration under certain circumstances.

Step 3.c: The issuing company may be granted an opportunity to remedy technical shortcomings.

Step 4: In the case of refusal, the FCSM notifies the company of its refusal within three days of adopting the decision.

Step 5: In the case of refusal, the issuing company has the right to appeal in court.

Source: IFC, March 2004

[432] FCSM Regulation No. 03-30/ps, Section 2.6.13.

[433] Law on the Securities Markets, Article 26.

5. The Sale of Securities

The issuer can begin selling securities once the state registration of the issue has been completed, unless otherwise provided by law.[434] The placement is the actual transaction between the company and the investor.[435] This transaction is subject to a number of legal requirements and only takes effect upon the registration of its results, as discussed hereinafter.

a) Number of Securities Placed

The number of securities placed should be no more than indicated in the decision to issue securities.[436] If a company places more than the number indicated in the prospectus, it is obliged to repurchase the surplus securities and cancel them within two months.[437] If the company fails to do so, the FCSM can file a claim in court for the return of the issue proceeds.

The number of securities placed may, however, be less than the number indicated in the prospectus. In practice, the ability of a company to sell securities depends on investor demand. Whatever its stated goal, the actual number of securities placed must be disclosed in the report on the results of the issue.[438]

b) The Timing of the Placement

The placement of securities must occur within a legally defined period of time:[439]

- **Minimum:** When securities are placed by subscription requiring the registration of a prospectus, the subscription cannot start earlier than two weeks after the publication of the announcement of the state registration of the issue. This requirement aims to provide a minimum period for investors to effectively acquaint themselves with the conditions of the investment. The

[434] Law on the Securities Market, Article 24.

[435] Law on the Securities Market, Article 2.

[436] Law on the Securities Market, Article 24.

[437] Law on the Securities Market, Article 26.

[438] Law on the Securities Market, Article 24.

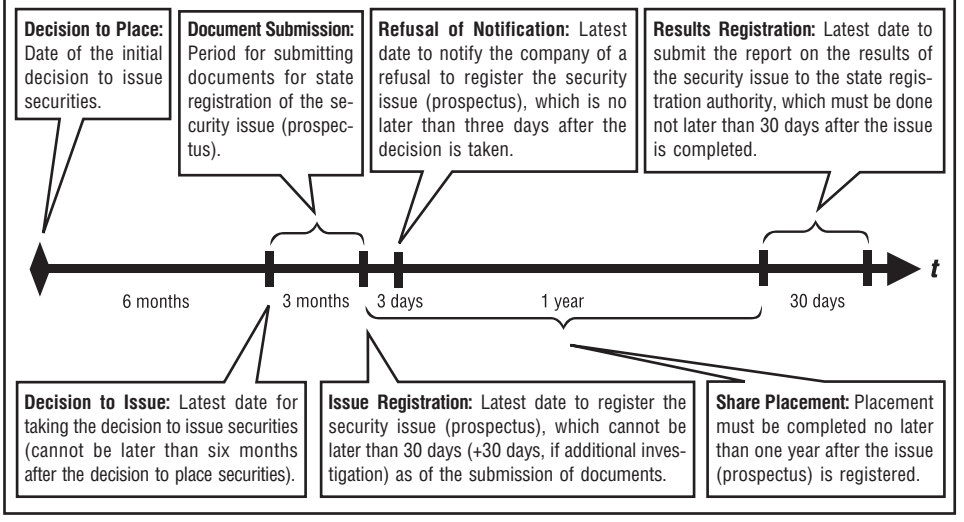
[439] Law on the Securities Market, Article 24.

subscription price, however, can be disclosed on the day when the placement of securities begins.

- **Maximum:** The placement must be completed no later than one year after the date of the state registration.

To carry out a legally valid securities issuance several deadlines must be met, as illustrated in Figure 3.

Figure 3: Share Issue Time Chart



Source: IFC, March 2004

c) Issue Price

The Supervisory Board has the right to determine the issue price of securities.[440] The discretionary powers of the Supervisory Board are limited, however, to prevent directors or large shareholders from acquiring securities below market price when the issue is done by subscription (see Table 4).

[440] LJSC, Article 36, Clause 1; Article 38, Clause 1.

Table 4: Issue Price	
Security	**Price**
Shares	• The issue price must correspond to the market value.[441] An Independent Appraiser can determine the market value of shares. The use of an Appraiser is not mandatory when share prices are quoted; and • The issue price cannot be lower than the nominal value. When shareholders exercise pre-emptive rights, the price cannot be lower than 90% of the market value.[442]
Convertible bonds (or options)	• The issue price must correspond to the market value;[443] and • The issue price cannot be lower than the nominal value of the shares into which they are to be converted.[444] In this case, similar to shares, shareholders, when exercising their pre-emptive right, can acquire convertible bonds at a price no more than 10% lower than the price determined for other investors.[445]
Bonds	• The issue price must correspond to the market value.[446]

D. The Conversion of Securities

Companies not only issue securities when seeking to raise capital, but also when existing securities, or rights embodied in them, must be restructured. A conversion of securities occurs in the following circumstances:[447]

- Increasing the charter capital by increasing the nominal value of shares;
- Decreasing the charter capital by decreasing the nominal value of shares;
- Consolidating or splitting shares;
- Converting one type and class of shares into another type and class of shares;

441 LJSC, Article 77.

442 LJSC, Article 36, Clause 1; Article 38, Clause 2.

443 LJSC, Article 38, Clause 1; Article 77.

444 LJSC, Article 38, Clause 1.

445 LJSC, Article 38, Clause 2.

446 LJSC, Article 77.

447 FCSM Regulation No. 03-30/ps, Section 5.1.1.

- Converting bonds into shares; and
- Reorganizing the company.

In these cases, new investors are not involved. Shares are placed with existing shareholders or other investors holding securities that grant them a conversion right. The procedure for converting existing shares is simpler and quicker than for issuing additional shares: no prospectus needs to be prepared and registered and the conversion of shares must be completed no later than one month from the date of the state registration of the issue.[448]

E. Share Splits and Consolidations

Shares are issued in specific quantities and at a given nominal value. Yet, during the life of a company, the nominal value can be altered without changing the amount of the charter capital. This can occur either through share splits or consolidations:

- Shares are split when the company exchanges one share of the company for two or more shares of the same type and class.[449] The result is an increase in the number of shares with a lower nominal value and lower market value per share. The most common share splits are 3-for-2, 2-for-1, and 3-for-1.
- Shares are consolidated when the company exchanges two or more shares for a lesser number of shares of the same type and class.[450] The result is fewer shares with a higher nominal value and a higher market value per share.

There are three main reasons for a share split: affordability, message, and psychology. Since shares are generally traded in blocks, splitting the shares and price reduces the minimum investment required to purchase a block of shares. Share splits can then make shares more affordable for small investors, and the increase in the number of shares may improve liquidity. Moreover, splits are often used to send "a message" to the markets that management is confident in the future of their company and it expects the share price to increase. There also

[448] FCSM Regulation No. 03-30/ps, Section 5.3.1.

[449] LJSC, Article 74, Clause 2.

[450] LJSC, Article 74, Clause 1.

may be a psychological benefit in that shareholders own two (or more) shares for the price of one.[451]

The decision to split or consolidate shares is subject to special procedures, as illustrated in Figure 4.

Figure 4: The Procedure for Splitting and Consolidating Shares

Step 1: The Supervisory Board submits a proposal to the GMS agenda to split or consolidate.

Step 2: The GMS approves the decision to split or consolidate.

Step 3: The Supervisory Board makes a decision to issue shares.

Step 4: The FCSM registers the share issue.

Step 5: The company converts issued shares.

Step 6: The FCSM registers the report on the results of the issue.

Step 7: The company amends the charter.

Step 8: The state registration authority registers the charter amendments.

Source: IFC, March 2004

The discussion in the following section will focus on the steps related to the decision-making requirements within the company (steps 1 and 2) and the charter amendments (steps 7 and 8). Steps 3 to 6, which represent the process of converting shares with a higher or lower nominal value into shares with a respectively lower or higher nominal value, have already been addressed in Section C of this Chapter.

[451] None of these reasons are corroborated by financial theory. Finance theory argues that splits and consolidations are largely irrelevant. Nevertheless, many western companies continue to split and consolidate shares.

1. Agenda Proposal to Split or Consolidate Shares

The decision to split or consolidate shares must be approved by the GMS.[452] However, only the Supervisory Board has the authority to propose splits or consolidations to the agenda of the GMS, unless the charter provides otherwise.[453] A simple majority vote of directors participating in the Supervisory Board meeting must approve the decision, unless the charter or by-laws require a greater percentage of votes.[454]

2. Decision to Split or Consolidate Shares

The GMS approves the decision to split or consolidate shares by a simple majority vote of participating shareholders.[455]

If the decision to split shares results in charter amendments that limit the rights of preferred shareholders, separate votes of the following groups of shareholders are required with the following majorities:

- A 3/4-majority vote of preferred shareholders whose rights are being limited, unless the charter requires a greater number of votes;[456] and
- A 3/4-majority vote of all other shareholders participating in the GMS.

Information included in the decision to split or consolidate shares is summarized in Table 5.

[452] LJSC, Article 48, Clause 1, Section 14.

[453] LJSC, Article 49, Clause 3.

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

[455] LJSC, Article 74, Clause 1; Article 49, Clause 2.

[456] LJSC, Article 32, Clause 4, Paragraph 2.

Table 5: Information Included in the Decision to Split or Consolidate Shares		
	Required	**Optional**
Consolidation[457]	• Types and classes of shares to be consolidated; • The number of shares of each type and class to be consolidated into one share of the same type and class (the consolidation ratio). The ratio must be a whole number. Fractions of a whole number are not allowed; and • The form of placement of shares (in this case the conversion of placed shares into shares of the same type and class but with a higher nominal value).	• The date, or the procedure for determining the date, when shares must be converted; and • Other significant terms and conditions of the consolidation.
Split[458]	• Types and classes of shares to be split; • The number of shares of each type and class into which one issued share of the same type and class will be split (the split ratio). The ratio must be a whole number; and • The form of placement of shares (in this case, the conversion of issued shares into shares of the same type and class but with a lower nominal value).	• The date, or the procedure for determining the date, when shares must be converted; and • Other significant terms and conditions of the split.

3. Charter Amendments

Companies are required to make charter amendments related to:[459]

- The nominal value of issued and authorized shares;
- The number of issued shares; and
- The number of authorized shares.

4. Registration of Charter Amendments

Charter amendments for share consolidations or splits must be registered with the state registration authority.[460]

[457] FCSM Regulation No. 03-30/ps, Section 5.1.4.

[458] FCSM Regulation No. 03-30/ps, Section 5.1.5.

[459] LJSC, Article 74.

[460] LJSC, Article 14.

F. Stock Options

A company may also issue options on securities.[461] Options are complex and often extremely risky derivative instruments (see Mini-Case 1).

> **Mini-Case 1:** A simple explanation of how an option functions is that it gives the holder the right to buy (or sell) an asset (generally share) at a pre-determined price. For example, an option may give the holder the right to buy company shares at today's price (e.g. RUR 1,000) in three months time. The holder of an option expects a change in the price of the underlying share from which he hopes to benefit. He may expect the price to rise to RUR 1,500. In this case, the option holder stands to gain RUR 500. On the other hand, if the price of shares falls, the option has no value. There are many different types of options that can be used to create complex tools for managing and trading risk.

In the corporate governance context, a relatively mundane form of option — the incentive stock option — is used to provide performance-enhancing incentives to management and employees. In some countries, options are the primary component of remuneration packages for top executives. They are popular because the returns to executives can be large, they ostensibly align the interests of management and shareholders, and because the true cost of options (the dilution of other shareholders) is not readily apparent under current accounting standards.

> **Best Practices:** Stock option compensation is a complex and contentious remuneration technique that requires close examination by the governing bodies of the company.

The issue of stock options must normally be accompanied by the issue of new shares. For this reason, the decision to place options must be carried out in accordance with the rules on convertible securities.[462] More specifically, a company

[461] Law on the Securities Market, Article 2.

[462] Law on the Securities Market, Article 2.

can only sell options after the charter capital is fully paid and if the number of authorized shares is not less than the number of shares subject to the exercise of the options rights.[463]

The quantity of shares that can be obtained when the option is exercised cannot exceed 5% of the shares of this type and class issued on the date of the submission of the documents for state registration of the options issue. Treasury shares may also be used for the exercise of stock options.

Best Practices: The use of other derivative instruments is important from a risk management perspective. The power of derivatives and similar instruments, such as hedges and futures, lies in their capacity to adjust the company's circumstances to any particular situation that arises. Options can be speculative or conservative. This means that various goals can be pursued, ranging from protecting companies from changes in commodity prices to gambling on the movement of shares. However, derivative and related instruments are complex and can be extremely risky. Supervisory Boards, and indeed shareholders, need to be aware of the company's use of these tools since they could potentially expose companies to unexpected and significant risks.

G. Raising Capital in the International Markets

Russian companies are increasingly seeking capital in international markets. Listings on foreign exchanges often bring advantages including a lower cost of capital, higher liquidity, and, last but not least, greater prestige. The world's largest foreign markets tend to have higher standards of corporate governance than the Russian markets. The most popular markets are in the U.S., the U.K., and continental Europe, which arguably have some of the most rigorous governance standards in the world.

The Law on the Securities Market allows Russian companies to issue shares abroad, after receiving permission from the FCSM.[464] Permission is generally granted subject to the following conditions:

[463] Law on the Securities Market, Article 27.1.

[464] Law on the Securities Market, Article 16.

- The state registration of the issue;
- The securities of the Russian issuer have been listed on at least one exchange in Russia;
- The quantity of securities placed abroad does not exceed a quota established by the FCSM; and
- The contract embodying the derivative rights to the company's shares cannot contain a clause that under a foreign law might grant a right to vote the securities without investor instructions.

The FCSM must decide on the foreign issue within 30 days of the submission of the required documentation.

There are two principal means for companies to establish a presence in the international securities markets. Companies can either: 1) issue securities directly; or 2) issue depositary receipts. Depositary receipts are contracts with foreign financial institutions, pursuant to which certificates are traded in lieu of shares. Depositary receipts are an increasingly popular form of accessing foreign capital. Depositary receipts are also used to give their holders the benefit of being able to have recourse to Russian law, with which they are familiar. Depositary receipts also contribute to increasing the liquidity of the issuing company's shares.

There are different types of depositary receipts, depending upon the market where they are traded. American Depositary Receipts (ADRs) circulate in U.S. stock markets, European Depositary Receipts (EDRs) circulate in European markets, and Global Depositary Receipts (GDRs) circulate in both.

The issue of depositary receipts is negotiated with individual banks as part of a contract that results in depositing the company's shares with the bank. Depositary receipts are popular with investors in foreign countries because of the added credibility given to them by the issuing banks, and because the investment is *de facto* a domestic investment. Depositary receipts offer a number of advantages over direct issues:

- Contracts are easier to satisfy than direct listings;
- Depositary receipts are less expensive than direct listings; and
- The placement of depositary receipts is often easier than the issue of shares on foreign stock exchanges, especially if the company is not well known on the foreign market.

Best Practices: Depositary receipts have corporate governance implications for investors. Shares are typically voted by the bank within which they are deposited, rather than by the holders of the receipt. This could be an advantage. Banks are able to combine the votes of many shareholders and thus be more effective in exerting influence over companies. On the other hand, it may be a disadvantage since the investor is unable to assert his views. In addition, intermediaries often vote with management as a matter of practice. The services of depository banks are an extra tier of relationships between the company and the ultimate investor, and can lead to additional costs. Thus, depositary receipts, like any other investment vehicle, require careful evaluation from the perspective of both the issuer and the investor.

Chapter 12

Material **Corporate Transactions**

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The Chairman's Checklist

Extraordinary Transactions:

- ✓ Do all directors understand the concept of extraordinary transactions? Does the company charter specify additional criteria for identifying transactions that are to be treated as extraordinary beyond the minimum criteria mandated by law? Does the Supervisory Board distinguish between extraordinary transactions and those entered into in the ordinary course of business?
- ✓ How does the Supervisory Board ensure that extraordinary transactions are properly evaluated and approved by the Supervisory Board or shareholders? Does the Supervisory Board ensure that an Independent Appraiser is engaged to ascertain the market value of assets involved in the transaction?
- ✓ What steps are taken to protect the rights of shareholders who do not approve of extraordinary transactions?
- ✓ Does the company properly disclose information on completed extraordinary transactions?

Control Transactions:

- ✓ Has the company ever been involved in control transactions? How does the Supervisory Board make sure that minority shareholder rights are properly protected in control transactions?
- ✓ Does the Supervisory Board take adequate measures to inform shareholders of the advantages and disadvantages of a change in control? Does the Supervisory Board allow unwarranted takeover defenses?
- ✓ Does the Supervisory Board ensure that any new controlling shareholder extends a mandatory bid at a fair price for outstanding common shares and convertible securities?

Related Party Transactions:

- ✓ Does the Supervisory Board ensure that related parties properly disclose their interest in transactions? Do related parties abstain from participating in discussing and voting on such transactions?
- ✓ Does the Supervisory Board ensure that all legal requirements for the approval of related party transactions are adhered to? What role do independent directors play in related party transactions?

- ✓ Does the Supervisory Board take adequate measures to disclose information on related party transactions and related parties?
- ✓ Do all directors understand their liability for violating procedures for approving related party transactions?

Shareholders are legally protected when the company is involved in extraordinary, control, and/or related party transactions. Such protection is essential because of the impact that these transactions can have on the value of the company, the price of its shares, and the property rights of shareholders. Nevertheless, corporate governance abuses in these types of transactions continue to take place. For example, beneficial ownership structures typically remain non-transparent, making it near impossible to identify related parties in a transaction. In the meantime, insiders continue to develop complex structures and sophisticated techniques that allow them to tunnel assets, profits, and corporate opportunities away from the company and its shareholders.

The protection of shareholders under these circumstances receives considerable attention in the Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code) and is described in detail in this chapter.

A. Extraordinary Transactions

1. Definition

The Company Law refers to and defines extraordinary transactions.[465] The Supreme Arbitration Court has interpreted the legal definition and applied it to specific transactions.[466] Furthemore, companies have the right to set additional criteria for defining extraordinary transactions, which is most commonly done in the company charter.

[465] Law on Joint Stock Companies (LJSC), Article 78, Clause 1.

[466] Information Letter No. 62, Overview of Practices of Resolving Disputes Related to the Conclusion by Commercial Companies of Extraordinary and Related Party Transactions, the Presidium of the Supreme Arbitration Court of the Russian Federation, 13 March 2001, Sections 1, 4 and 6.

A transaction (or several related transactions) is extraordinary when it meets all five of the following criteria:

a) The Nature of the Transaction

- The transaction directly or indirectly involves the acquisition, sale, or the possibility of sale of corporate assets;
- The transaction is a credit, pledge, or guarantee transaction; and
- The transaction is not related to the issue of additional common shares or securities convertible into common shares.

b) The Value of the Transaction

The assets involved have a value of 25% or more of the book value of the company's assets as determined by financial statements as of the most recent reporting date.

c) The Relation of the Transaction to the Business of the Company

The transaction is not being carried out in the "ordinary course of business" of the company.

The Company Law does not define the "ordinary course of business." Whether a transaction qualifies as such will depend on company-specific factors. For example, the purchase of real estate may be an extraordinary transaction if the company is generally engaged in the trade of consumer goods. However, the same transaction would not be extraordinary if the core business is trading in real estate. In other words, the same transaction that could be in the ordinary course of business for one company may not be for another. The Supreme Arbitration Court lists some transactions that could fall under the "ordinary course of business."[467] In particular, they are:

- Transactions to acquire raw materials and materials necessary for company's business activities;
- Sale of produced goods; and
- Obtaining loans to fund its ordinary operations.

[467] Resolution No. 19, the Plenum of the Supreme Arbitration Court, on Certain Issues of Application of the Law on Joint Stock Companies (Resolution No. 19), 18 November 2003, Section 30.

d) Related Transactions

Two or more related transactions involving company's assets totaling 25% or more of the book value of the company's assets are considered a single extraordinary transaction.[468] Factors that determine whether several transactions must be considered as a single transaction extraordinary include:

- The purpose of the transactions;
- The market conditions under which the transactions have been concluded;
- The sphere of activities of the company; and
- The duration of relationships between the company and its transactional counterpart.

e) Additional Charter Criteria

The charter may define additional transactions that should be treated as extraordinary transactions.[469] For example, the charter may specify that transactions involving assets with a lower percentage of the book value be considered an extraordinary transaction. The charter can also provide that certain types of contracts (e.g. all loan agreements or all pledges of company shares) must be treated as extraordinary transactions, regardless of their nature. However, the company has no right to change the legal definition of an extraordinary transaction to limit cases of extraordinary transactions. For example, the company cannot provide that only transactions involving assets with a value in excess of 30% of the book value of the company's assets will be considered as extraordinary transactions.

Best Practices: There are many cases when transactions should be subject to special procedures for extraordinary transactions, even though they fall well below the legislated threshold of 25%. For example, the sale of a subsidiary of a large petroleum company that holds significant oil drilling rights may be of such size and strategic importance that it should be considered an extraordinary transaction regardless of the percentage of asset value it represents.

Legislation establishes a minimum standard of behavior, and there is some room for various interpretations regarding what is extraordinary and what is not. For this reason, it is good practice for charters to include provisions that "transac-

[468] LJSC, Article 78, Clause 1, Paragraph 1.

[469] LJSC, Article 78, Clause 1.

tions that may have a significant effect on the company" be treated as extraordinary (except for transactions that are concluded in the ordinary course of business).[470]

It is also recommended that the sale of shares of a subsidiary where the company would lose its majority stake be considered extraordinary transactions.

When two companies are engaged in a transaction, each company must separately apply the criteria for extraordinary transactions. This means that the same transaction may conceivably be an extraordinary transaction for one company but not for the other.

2. Exempted Transactions

Under certain circumstances, companies are not required to follow all the approval procedures for concluding an extraordinary transaction. Exceptions are granted when the extraordinary transaction is:

- Executed by a company owned by a single shareholder who is also the General Director;[471] or
- Simultaneously a related party transaction.[472] In this case, the company follows the procedures for related party transactions.

➜ *For more information on related party transactions, see Section C of this Chapter.*

3. Valuing Extraordinary Transactions

An important aspect in determining whether a transaction is an extraordinary transaction is to value the assets involved in the transaction. The value of these assets must be determined to ascertain which governing body approves the transaction before the company can conclude the transaction. The Supervisory Board

[470] Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), Chapter 6, Section 1.1.

[471] LJSC, Article 79, Clause 7.

[472] LJSC, Article 79, Clause 5.

[473] LJSC, Article 77; 78, Clause 2.

has the authority to determine the value of assets or services.[473] In doing so, the Supervisory Board must compare the book value of the assets involved in the transaction with the book value of the company's assets as a whole. This comparison depends on the nature of the transaction whether it is an acquisition or a sale, as illustrated in Table 1.[474]

Table 1: Determining a Transaction's Value	
Type of Transaction	**Basis of Valuation**
Sale, or the possibility of a sale, of assets	The value of assets involved in the transaction as determined by reference to the company's financial statements as of the most recent reporting date before the transaction.
Acquisition of assets	The acquisition price of assets involved in the transaction.

Best Practices: An Independent Appraiser should assist the Supervisory Board in determining the value of assets.[475]

If the state or a municipal entity owns more than 2% of voting shares, the Supervisory Board is required to involve the state financial control agency in the valuation of the assets in extraordinary transactions.[476] This can be a control agency of the Ministry of Finance (such as the Department of State Financial Control and the regional Control and Revision Departments), the Chief Control Department of the President of the Russian Federation, or a local state financial body.

4. Approving Extraordinary Transactions

A transaction must be approved by different governing bodies depending on the value of assets as illustrated in Table 2.

[474] LJSC, Article 78, Clause 1, Paragraph 2.

[475] LJSC, Article 77, Clause 2. See also: FCSM Code, Chapter 6, Section 1.3.

[476] LJSC, Article 77, Clause 3.

Table 2: The Approval of Extraordinary Transaction	
Value of Assets	**Approving Governing Body**
Between 25% and 50% of the book value of the company's assets	The Supervisory Board[477]
More than 50% of the book value of the company's assets	The General Meeting of Shareholders (GMS)[478]

The Supervisory Board has the authority to approve those extraordinary transactions that are defined as such by the charter.[479]

a) Transactions Involving Between 25% and 50% of the Book Value of Company Assets

Unanimous approval of all serving Supervisory Board members is required to approve an extraordinary transaction involving assets with a value between 25% and 50% of the book value of the company's assets.

If the Supervisory Board is not able to reach a unanimous decision, it can request that the GMS approve the transaction. The Supervisory Board can do this by a simple majority vote of directors participating in the Board meeting, unless the charter or by-laws require a higher percentage of votes. The GMS can then approve the transaction with a simple majority vote of participating shareholders.[480]

b) Transactions Involving More than 50% of the Book Value of Company Assets

The GMS must decide on whether to approve transactions involving more than 50% of the book value of company assets by a ¾-majority vote of participating shareholders.[481]

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[477] LJSC, Article 79, Clause 2, Paragraph 1.

[478] LJSC, Article 79, Clause 3.

[479] This decision cannot be approved by the GMS because the company charter cannot delegate additional powers to the GMS beyond those defined by law.

[480] LJSC, Article 79, Clause 2, Paragraph 2; Resolution No. 19, Section 32.

[481] LJSC, Article 79, Clause 3.

c) Required Information for the Decision to Approve an Extraordinary Transaction

The decisions of the Supervisory Board or the GMS must include information on:[482]

- The parties that are involved in the transaction;
- Other beneficiaries of the transaction (if any);
- The price of the transaction;
- The object of the transaction; and
- Any other significant terms and conditions related to the extraordinary transaction.

5. How Shareholders Can Protest Extraordinary Transactions

If a shareholder does not agree with an extraordinary transaction conducted in full compliance with procedural requirements and the law, he may:

- **Sell his shares.** Practically, this is only possible if the company's shares are liquid, i.e. there are interested buyers and shareholders are able to sell their shares at a fair price; or
- **Demand redemption of shares in part or whole:** Shareholders have the right to have their shares redeemed by the company.[483]

6. Disclosure Requirements

Companies are required to include the following information on extraordinary transactions in their annual reports:[484]

- A list of all extraordinary transactions concluded by the company during the reporting year;

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[482] LJSC, Article 79, Clause 4.

[483] LJSC, Article 75, Clause 1 provides that redemption rights only arise when the extraordinary transaction involves assets or services, the value of which is 50% or less of the book value of company assets. However, the Plenum of the Supreme Arbitration Court has interpreted this provision to include extraordinary transactions involving assets with a value of more than 50% of the book value of company's assets (see also: Resolution No. 19, the Plenum of the Supreme Arbitration Court, on Certain Issues of Application of the Law on Joint Stock Companies, 18 November 2003, Section 29).

[484] FCSM Regulation No. 17/ps on Additional Requirements to the Procedure of Preparation, Calling, and Conducting of the General Meeting of Shareholders, 31 May 2002, Section 3.6.

- A list of transactions that are considered extraordinary based on the definition in the charter;
- Key terms of each extraordinary transaction; and
- The governing body that approved each transaction.

Companies must also disclose information on extraordinary transactions in their prospectus and quarterly reports.[485] For the registration of the secured bond issue and the report on the results of issue, the company must submit the meeting minutes of the approving body with information on the quorum and the voting results to the registration agency.[486]

Companies are required to provide information on extraordinary transactions in the "disclosure appendix" or notes to financial statements related to the acquisition or the disposition of fixed assets and investments.[487]

Audit standards provide that the External Auditor must review extraordinary transactions with related parties to identify the true conditions under which such transactions took place.[488]

7. Invalidating of Extraordinary Transactions

The company and its shareholders have the right to request the court to invalidate an extraordinary transaction if the decision-making body of the company failed to follow appropriate procedures.[489]

However, according to the Supreme Court and the Supreme Arbitration Court, an extraordinary transaction that was invalidated due to procedural violations may

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[485] Annex 4 of FCSM Regulation No. 03-32/ps on the Disclosure of Information by Issuers of Securities, 2 June 2003, Section 10.1.6; Annex 11 of FCSM Regulation No. 03-32/ps, Section 8.1.6.

[486] FCSM Regulation No. 03-30/ps on the Standards of Security Issue and Registration of Security Prospectuses, 18 June 2003, Sections 2.4.7, 6.5.1; Annex 9 of the Standards, Section 11.

[487] Decree No. 56n, the Ministry of Finance, on the Approval of Rules on Accounting Events After the Reporting Date, Section 2. It is, however, unclear whether the term "extraordinary transaction" in this act has the same meaning as in the Company Law.

[488] Audit Standard on Accounting Operations With Related Parties During an Audit, Section 4.2, a). It is not clear whether the term "major transactions" in this act has the same meaning as in the Company Law.

[489] LJSC, Article 79, Clause 6.

be re-validated if approved after the fact by the GMS (or the Supervisory Board, where applicable).

Best Practices: Russian legislation appears inadequate in protecting the interests of the company's counterparts in extraordinary transactions. If the company can seek to invalidate a transaction that was not concluded in accordance with the company's internal approval procedures then this may create undue problems for the counterpart. It is recommended to follow the example of some western jurisdictions where the company needs to prove that the counterpart in the transaction knew or must have known of the irregularity of its approval.

B. Control Transactions

Control transactions are transactions in which a person (or a group of affiliated persons) acquires a controlling block of shares, defined in the Company Law as 30% or more of the company's common shares.[490] Control transactions are also referred to as takeovers.

Best Practices: The market for corporate control, together with the product, labor, and capital markets, is a distinct feature of a market economy. Generally, markets for corporate control represent the historical development of a distinct fourth type of market, in which the trading of corporate equity occurs on a very large scale and bestows the power to control these corporations. Takeovers are a key mechanism in the dynamic allocation of corporate control; they allow the removal of inefficient managers (against their will) and exploitation of synergies between firms. Moreover, the mere threat of a takeover affects the behavior of those entrusted with control, i.e. disciplines them. Consequently, a functioning takeover market is widely considered an important component of — if not a prerequisite for — an effective governance system.

Over the last several decades, the issue of regulating takeovers has become increasingly important. In the EU, for example, the Thirteenth Company Law

[490] LJSC, Article 80, Clause 1.

Directive on Takeover Bids was recently adopted. In contrast to Russian law, it attempts to apply takeover rules to listed companies and specifically deals with voluntary bids, which are not regulated by Russian legislation. Voluntary bids, which are also called tender offers, are a means of public offer to acquire shares of the company leading to a change of control. There are specific rules that deal with the disclosure and terms of such bids.[491]

Takeovers result in changes to company control, strategy, decision-making, and, generally, lead to the replacement of the acquired company's directors and senior managers. One of the economic benefits of takeovers is that they may result in improved utilization of company assets. This, in turn, should benefit all shareholders. On the other hand, takeovers have considerable potential for abusing minority shareholder rights.

Best Practices: Changes of control may occur on a voluntary basis by consolidation or merger, as agreed upon by shareholders and managers of participating companies. Control can, however, also pass hands in a hostile manner, i.e. when directors and managers of the target company resist the takeover attempt. The negative implications of change of control situations not only relate to pre-change possibilities of abuse (for example, two-step tender offers, during which the acquiring company offers different prices to different groups of shareholders), but also to post-change challenges that non-controlling shareholders might face (for example, changes to the dividend policy or increases in executive remuneration, to the detriment of minorities).

In case of voluntary change of control, shareholders have a say in the results and expressly agree with all consequences. In case of hostile takeovers, directors and managers typically have more opportunities to resist the value-increasing changes of control in their own interests. At the same time, if a hostile takeover attempt succeeds, minority shareholders who did not agree with the change of control risk being in the situation where the new controlling shareholder may abuse its position and retaliate for such behavior of shareholders.

[491] For more information on EU Thirteenth Directive and voluntary bids, see http://europa.eu.int/eur-lex/en/archive/2004/1_14220040430en.html.

In Russia, companies with more than 1,000 shareholders with common shares must follow special procedures both before and after the acquisition of 30% or more of common shares.[492] Companies are also required to follow procedures for control transactions each time the controlling shareholder(s) acquires an additional 5% or more of common shares (e.g. 35%, 40%, 45%, and 50%).[493]

Company Practices in Russia: Control transactions are of particular concern to many Russian companies today, given the current consolidation wave taking place in many sectors. More specifically, smaller, successful companies and their (minority) shareholders often become subjects of abuse by large companies through hostile takeovers. In many instances, however, takeovers are not carried out through the typical market mechanisms (e.g. by extending a tender offer to shareholders) but rather through block sales. Moreover, certain illegal methods to overrule privatization results are used to circumvent proper control transactions, e.g. dubious lawsuits that paralyze the company and often bring it to the verge of bankruptcy. Under these circumstances, the role of the judiciary, the FCSM, and other enforcement bodies becomes particularly important in protecting companies and shareholders.

1. Affiliated Persons

The concept of affiliated persons is important in the context of control transactions because shares acquired by affiliated persons are added up when determining whether a transaction is a control transaction. An affiliated person is defined as an individual or a legal entity that can influence the activity of legal entities, and/or individual engaged in entrepreneurial activity.[494] Consequently, the following are considered affiliated persons of a legal entity:

- A Supervisory Board member;
- The General Director or an Executive Board member;
- The External Manager;

[492] LJSC, Article 80, Clause 1.

[493] LJSC, Article 80, Clause 7.

[494] Law on Competition and Limitation of Monopolistic Activities in Commodities Markets (Antimonopoly Law), Article 4.

- Any legal entity that is part of the same group of companies[495] to which the company belongs;
- Any individual who possesses more than 20% of votes in the company;
- Any legal entity, in which the company possesses 20% of votes; and
- A member of the Supervisory Board or the Executive Board, the General Director, and the External Manager of other members of the company's Financial and Industrial Group (FIG).

➜ *For more information on FIGs, see Part V, Chapter 15, Section B.4.*

The following persons are considered affiliated persons of an individual, e.g. Individual (B) who carries out entrepreneurial activity:

- Any individual or legal entity belonging to the same group to which Individual (B) belongs; and
- Any legal entity in which Individual (B) has more than 20% of voting shares (participatory shares, units).

➜ *For more information on disclosure requirements of affiliated persons, see Part IV, Chapter 13, Section B.3.*

2. Pre-Acquisition Requirements

An individual, legal entity, or group of affiliated persons must notify the company in writing when they intend to acquire:

- 30% or more of the company's common shares; or
- Shares that will lead to the ownership of 30% or more of common shares.[496]

This notification must be sent to the company no earlier than 90 days before the shares will be acquired, and no later than 30 days before the acquisition.[497]

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[495] Antimonopoly Law, Article 4.

➜ *For more on groups of companies, see Chapter 15.*

[496] LJSC, Article 80. Note that the Company Law refers only to common shares and does not include voting preferred shares and convertible securities. Since control transactions are aimed at acquiring control of the target company, buyers seek to acquire voting shares.

[497] LJSC, Article 80, Clause 1. Russian legislation does not specify what information must be included in the notice of the intention to acquire 30% or more of common shares.

Best Practices: If notice of an intent to acquire control is received by the company, the Supervisory Board should:[498]

- Have an Independent Appraiser determine the market value of common shares; and
- Inform shareholders of the possible consequences of the acquisition of shares.

This should enable shareholders to make an informed decision regarding whether to sell their shares to the person who intends to acquire a controlling block.

3. Post-Acquisition Requirements

A far more important procedural requirement found in the Company Law arises after the acquisition of a controlling block of shares.

a) Mandatory Bid

The controlling shareholder (or group of affiliated persons) is obliged to make an offer to purchase or buyout the remaining common shares (and other securities convertible into common shares) within 30 days after the acquisition of a controlling block. This is referred to as a "mandatory bid" or a "fair price requirement."

The mandatory bid must be sent to all common shareholders in writing and must include:[499]

- The name and address of the acquirer of the controlling block of shares;
- The number of acquired common shares;
- The price offered by the acquirer to shareholders (the buyout price);
- The period for accepting the mandatory bid; and
- The period for making the payment for shares and convertible securities.

Best Practices: It is good practice to submit the mandatory bid to shareholders not directly but through the company. The Corporate Secretary can assist in

[498] FCSM Code, Chapter 6, Section 2.1.1.

[499] LJSC, Article 80, Clauses 3 and 5.

forwarding the mandatory bid to shareholders in accordance with the notification procedures for the GMS.[500]

➜ *See also Chapter 8, Section B.4 on notification procedures for the GMS.*

Non-controlling shareholders have the right to accept the mandatory bid in no later than 30 days after they receive it. If accepted, the controlling shareholder is obliged to purchase the shares and/or convertible securities within 15 days of the non-controlling shareholder's acceptance of the mandatory bid at the buyout price.[501]

b) The Buyout Price

The buyout price for common shares and convertible securities must be at market value. At the same time, the price for common shares may not be below their average weighted market price over the six months preceding the acquisition.[502]

Best Practices: Control transactions usually include a so-called control premium, which is paid by the acquirer of control to selling shareholders. Some commentators argue that equal treatment of shareholders should also lead to sharing the control premium. Hence, the City Code on Takeovers and Mergers of the U.K. and EU Thirteenth Directive require that the mandatory bid equal the highest price that was paid for buying the control.[503]

c) Waiver of the Mandatory Bid Requirement

The acquirer of a controlling block of shares can be released from the obligation to make the mandatory bid in the following two situations:[504]

- **Charter exemption.** The charter may exempt the acquirer from the obligation to make a mandatory bid in relation to control transactions; or

[500] FCSM Code, Chapter 6, Section 2.4.

[501] LJSC, Article 80, Clause 4.

[502] LJSC, Article 80, Clause 2, Paragraph 1. Note that this article does not specify the date on which the market value of shares must be determined.

[503] For more information on mandatory bids, see the EU Thirteenth Directive at http://europa.eu.int/eur-lex/en/archive/2004/1_14220040430en.html.

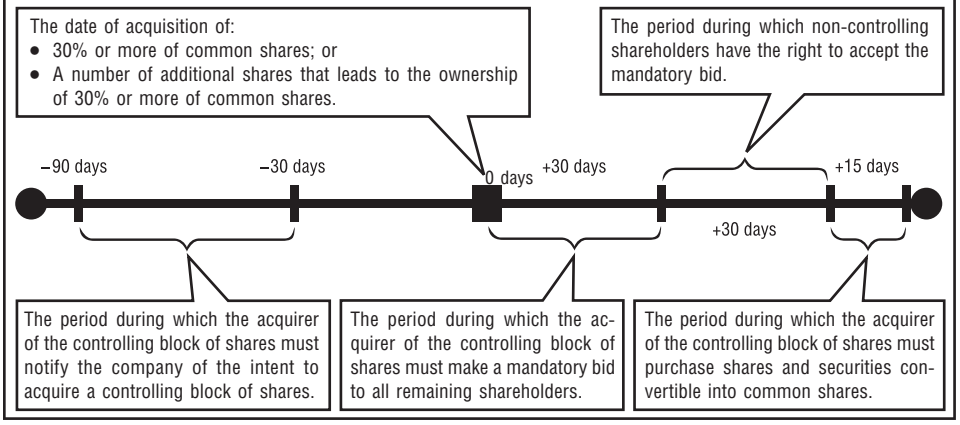
[504] LJSC, Article 80, Clause 2, Paragraph 2.

- **Transaction-specific exemption.** The GMS can exempt the acquirer from the obligation to make a mandatory bid. A simple majority vote of participating shareholders (excluding the votes of the acquirer of the controlling block of shares) is sufficient.

Best Practices: Neither the charter nor GMS should release the controlling shareholder(s) from the responsibility to buyout the shares of non-controlling shareholders.[505]

The timelines for carrying out control transactions are summarised in Figure 1.

Figure 1: Time Chart for a Control Transaction



Source: IFC, March 2004

Best Practices: In addition to the mandatory bid rule, legislation in western jurisdictions provides for an additional shareholder protection mechanism, the sell-out right.[506] The sell-out right allows minority shareholders to force the controlling shareholders (typically those with 90–95% of the charter capital) to purchase all their shares. The sell-out right is usually mirrored by a correspond-

[505] FCSM Code, Chapter 6, Section 2.3.

[506] For more information on sell-out and squeeze-out rights, see the EU Thirteenth Directive at http://europa.eu.int/eur-lex/en/archive/2004/1_14220040430en.html.

ing right of the controlling shareholder to force the exit of minority shareholders, the so-called squeeze-out right, if he owns 90–95% of the company's charter capital.

Companies wishing to follow good corporate governance practices will include both the sell-out and squeeze-out rights in their charter.

4. Anti-Takeover Measures

There are many legitimate reasons for opposing takeovers. Potential acquirers may not have credible business plans, or the price offered for the company may be too low. However, managers and directors often oppose takeovers simply because they will likely lose their jobs.

Best Practices: A guiding principle for Supervisory Boards to follow is for companies to never employ anti-takeover measures at the expense of shareholder rights and interests. There are different takeover defenses available under various legal systems. In any given jurisdiction, the application of various defenses depends on the national legal and regulatory framework, and judicial practice. Anti-takeover measures range from pre-takeover to post-takeover mechanisms. Some of the more famous measures include poison pills, crown jewels, golden parachutes, and white knights.[507]

The Supervisory Board should not issue additional shares, convertible securities, or securities that entitle holders to purchase shares of the company during the acquisition period of a controlling block of shares (even if an issue is authorized by the charter).[508]

[507] Poison pills are designed to make a hostile takeover prohibitively expensive. For instance, a company may issue a new series of preferred shares that grant its shareholders the right to redeem shares at a premium price after a takeover or allow all existing shareholders of the target company to buy additional shares at a bargain price, thereby deterring a takeover bid by raising the acquisition cost and causing dilution. White knight provisions include the issuance of preferred shares that the Supervisory Board may issue at any time to a "white knight" investor, i.e. a friendly investor sought out by the target firm. For more information on these and other anti-takeover provisions and their corporate governance implications, see the Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, 10 January 2002, Annex 4, Overview of the Most Important Barriers to Takeover Bids, p. 74. See also: http://europa.eu.int/comm/internal-market/en/company/company/news/hlg01-2002.pdf.

[508] FCSM Code, Chapter 6, Section 2.2.

5. Consequences of Procedural Violations

The acquirer of a controlling block may not vote shares acquired in violation of the legal procedures for control transactions.[509] Thus, the acquirer may only exercise rights attached to shares that were lawfully acquired below the 30% threshold.

If a controlling shareholder (who already owns at least 30% of common shares) acquires an additional 5% or more of common shares without advance notification or without offering to buy out the remaining common shares, he may only exercise the rights attached to the shares that were lawfully acquired.[510]

C. Related Party Transactions

Related party transactions involve insiders, such as directors, managers, large shareholders, or parties related to them. Some related party transactions have legitimate purposes and can be conducted fairly. Others do not. Regardless, they are easily abused and warrant particular attention since they may reduce the value of the company and expropriate shareholder rights. Legislation contains detailed procedures to discourage insiders from entering into related party transactions, and to help ensure fairness when a related party transaction does take place.

Related party transactions not only occur between the company and its directors, managers, and large shareholders, but more importantly, within groups of companies (holding structures), where transactions between the parent and subsidiary companies frequently occur.

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[509] LJSC, Article 80, Clause 6.

[510] Note that the Company Law refers to the limitation of voting rights attached to the controlling block of shares that were acquired in violation of procedures for control transactions. This means that all other rights, including the right to receive dividends, can be exercised. To enforce the buyout requirement, the law could require that shares acquired while violating the procedures for control transactions lose all rights and that they must be disposed of within a specified period.

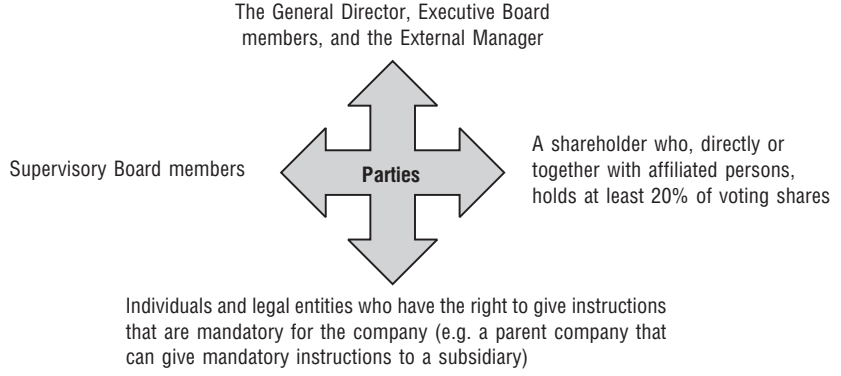
1. Definition

For a transaction to be considered a related party transaction, each company involved in the transaction must check whether two conditions are met.

a) Potentially Related Parties

A number of parties can be defined as related if they play a role in a transaction. Such parties are presented in Figure 2.[511]

Figure 2: Potentially Related Parties



Source: IFC, March 2004

Best Practices: The list of parties defined by the Company Law as related fails to cover key company officers in positions of control. For example, Deputy General Directors, Chief Accountants, and directors of representative offices and branches are not covered by the legal definition, unless they happen to also sit on the Executive Board. Companies wishing to follow good corporate governance practices may consequently wish to expand the list of potentially related parties in their charter.

The OECD Principles of Corporate Governance provide a general definition of related parties, including entities under common control, significant shareholders

[511] LJSC, Article 81, Clause 1.

including members of their families and business associates, and key management personnel.[512]

International Accounting Standard (IAS) Number 24.9 provides a more detailed definition, and thus parties are considered to be related if one party has the ability to control the other party or to exercise significant influence or joint control over the other party in making financial and operating decisions.[513] A party is related to an entity if:

1. Directly, or indirectly through one or more intermediaries, the party:
   - Controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries, and fellow subsidiaries);
   - Has an interest in the entity that gives it significant influence over the entity; or
   - Has joint control over the entity;
2. The party is an associate (as defined in IAS 28 Investments in Associates) of the entity;
3. The party is a joint venture in which the entity is a venturer (see IAS 31 Interests in Joint Ventures);
4. The party is a member of the key management personnel of the entity or its parent;
5. The party is a close member of the family of any individual referred to in (1) or (4);
6. The party is an entity that is controlled, jointly controlled, or significantly influenced by or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (4) or (5); or
7. The party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

At the same time, IAS 24.11 specifies which parties are not deemed related:

- Two enterprises simply because they have a director or key manager in common;
- Two venturers who share joint control over a joint venture;
- Providers of finance, trade unions, public utilities, government departments, and agencies in the course of their normal dealings with an enterprise; and
- A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.

[512] See 2004 OECD Principles of Corporate Governance on www.oecd.org/dataoecd/32/18/31557724.pdf.

[513] See also: the International Accounting Standard Board's website under www.iasb.co.uk.

The Financial Accounting Standards Board's (FASB) Statement No. 57 finally defines a related party as affiliates of an enterprise, trusts for benefits of employees, owners and their family members, investment entities accounted for by the equity method by the firm, management, and other large shareholders or parties that influence firm policy.

b) Related Parties Are Involved in the Transaction

For the purposes of defining related party transactions, the parties specified in the previous section as well as spouses, parents, children, sisters and brothers, adopted children, and adoptive parents of other potentially related parties listed in this Figure must be involved in the transaction in one of the following capacities:[514]

- Act as a transacting party, a beneficiary, an intermediary, or an agent in the transaction;
- Own at least 20% of voting shares (participatory shares, units)[515] in a legal entity which is a party, beneficiary, intermediary, or agent in the transaction;
- Hold a position in a governing body of a legal entity which is a party, beneficiary, intermediary, or agent in the transaction; or
- Other instances specified in the charter.

Mini-Case 1: Company (X) concludes a contract with Company (Y) that Company (Y) will sell products of Company (X) on-line. Mr. (A) is a Supervisory Board member of Company (X) and is also the General Director of Company (Z), which will receive a special discount on products of Company (Y) sold to Company (Z) if the transaction between Company (X) and Company (Y) is concluded. In such a transaction between Company (X) and Company (Y), Mr. (A) is considered a related party who is a beneficiary of the transaction. The transaction will be a related party transaction for Company (X) and will require approval. At the same time, it is not a related party transaction for Company (Y).

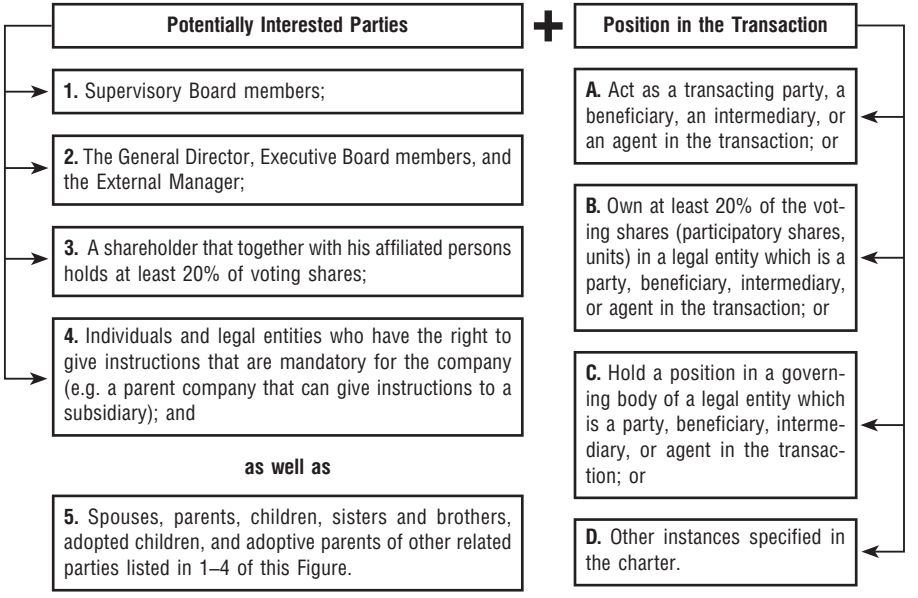
As illustrated in Mini-Case 1, it is important to note that the same transaction can be a related party transaction for one company but not for another. In this case, only one company needs to approve the transaction as a related party transaction.

[514] LJSC, Article 81, Clause 1.

[515] Participatory shares refer to limited liability companies, while units refer to production cooperatives.

Figure 3 depicts components of related party transactions, which must be present in a transaction.

Figure 3: Components of Related Party Transactions



Source: IFC, March 2004

To determine whether a transaction is a related party transaction, it is necessary for an interested party from the left column of Figure 3, be involved in the transaction as indicated in the right column of Figure 3. In practice, this means that a company must create a list of potentially interested parties and always check whether any of these parties (1–4 of the left column) or their affiliated persons (5 of the left column) is involved in each and every transaction carried out by the company, as mentioned in A — D of the right column.

Best Practices: Related party transactions are common in the context of groups of companies, e.g. in parent-subsidiary relations. If one company dominates another, there is a risk that the parent will utilize the subsidiary for its own busi-

ness objectives, without care for the subsidiary's long-term financial viability. In these cases, the creditors and shareholders of both the subsidiary and parent may be put at risk — often unknowingly.

- The risk for creditors at the subsidiary level is obvious. But the risk is present at the parent level as well, as the subsidiary's insolvency can greatly damage the surviving parent.
- Shareholders are also put at risk, although the position of shareholders at the subsidiary level is weaker. On the one hand, shareholders at the subsidiary level often benefit from being part of the parent's business. On the other, they may have to contribute to the parent's welfare to their own detriment.

➜ *For more information on intra-group transactions, and the important role the Supervisory Board plays, see Part V, Chapter 15, Sections B and C.*

2. Exempted Transactions

Companies are not required to comply with approval procedures if:[516]

- The transaction is executed by a company consisting of a single shareholder who is simultaneously the General Director;
- All shareholders are related parties in the transaction;
- The transaction is the exercise of pre-emptive rights by shareholders;
- The transaction is the buyback or the redemption of shares; or
- The transaction is a reorganization through merger (consolidation), and the other entity that participates in the merger (consolidation) owns more than 75% of voting shares of the company being reorganized.

3. Approving Related Party Transactions

Best Practices: There are different means of regulating related party transactions. Prohibitions of specific types of transactions are found in the U.K., where the U.K. Companies' Act prohibits directors from entering into certain transac-

[516] LJSC, Article 81, Clause 2.

tions that are deemed detrimental to the company.[517] The advantage of this first approach is clear: all practitioners know where the boundaries are. There will be no fine analysis as to the possibilities to circumvent the prohibition. The disadvantage is the rule's lack of flexibility: even economically useful transactions may not come into being when the law contains a flat prohibition. Additionally, parties may also make great efforts to circumvent the rule.

In some jurisdictions there have been calls to change the approach and foster more substantive criteria of fairness: transactions with conflicting interests should always be open to challenge on the basis of unfairness, at least gross unfairness. This second approach is frequently found in U.S. law, and in the U.K.[518]

Russia seems to have chosen a third option, also present in developed jurisdictions — to require specific approval procedures for related party transactions.

Related party transactions have to be approved by the GMS or the Supervisory Board, respectively, as illustrated in Table 3.

Table 3: The Approval of Related Party Transaction

Nature of the Transaction	Approving Body
• Value of assets involved in the sale (or the offer price) is 2% or more of the book value of the company's assets according to its financial statements for the last reporting period; or • Transaction relates to the placement by subscription or a sale of shares that are more than 2% of issued common shares and convertible securities; or • Transaction relates to the placement by subscription or a sale of convertible securities that are more than 2% of issued common shares and convertible securities.	The GMS[519]
• All other related party transactions.	The Supervisory Board[520]

[517] Section 330 (2), U.K. Companies Act.

[518] See in the U.K., the Law Commission, Company directors: Regulating conflicts of interest and formulating a statement of duty, September 1999, p. 282, document Law Com No. 261.

[519] LJSC, Article 83, Clause 4.

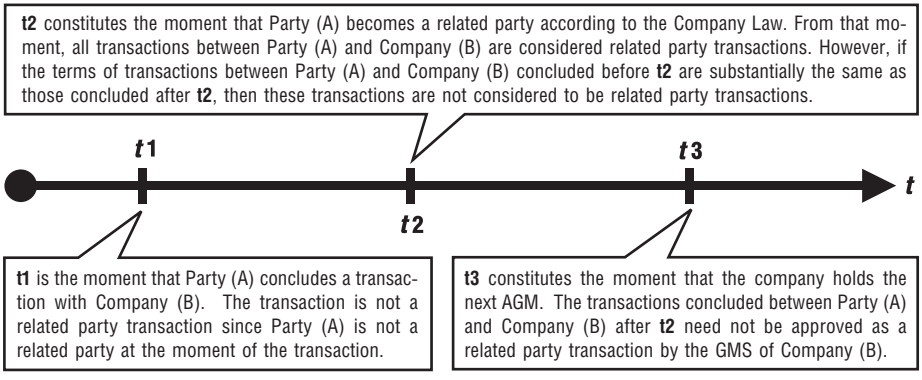
[520] LJSC, Article 83, Clause 2; Article 83, Clause 3, Paragraph 1.

a) Approval by the GMS

A simple majority vote of shareholders participating in the GMS (excluding votes of related parties) is required to approve a related party transaction. The GMS may adopt a decision to approve a future transaction between the company and a related party, as long as it is concluded in the course of the company's ordinary business activities. In this case, the decision of the GMS must specify the maximum amount of the transaction. The decision remains in force until the next Annual General Meeting of Shareholders (AGM).[521]

The GMS is not required to approve a related party transaction if the terms of the transaction are substantially similar to past transactions with a person before such person became a related party.[522] This exception applies to related party transactions until the next AGM, as illustrated in Figure 4.

Figure 4: Related Party Transactions and the Ordinary Course of Business



Source: IFC, March 2004

b) Approval by the Supervisory Board

The Supervisory Board has the authority to approve related party transactions if they do not fall under the authority of the GMS. The legal requirements for decision-making thresholds differ depending upon the number of shareholders in the company:

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[521] LJSC, Article 83, Clause 6, Paragraph 2.

[522] LJSC, Article 83, Clause 5.

- **In companies with 1,000 and fewer shareholders with voting rights**, the decision to conclude a related party transaction must be made by a majority of directors participating in the Supervisory Board meeting and who are not related parties.[523] This means that directors who are related parties:[524]
  - — Must inform the Supervisory Board about their interest in the transaction; and
  - — Must abstain from participating in the decision of the Supervisory Board on the transaction.

"Interested" members are not counted for the quorum. The decision to approve a related party transaction must be adopted by the GMS if the number of disinterested directors is insufficient to meet the quorum.[525]

- **In companies with more than 1,000 shareholders with voting rights**, the decision to conclude related party transactions must be made by a majority of independent directors who are not related parties.[526] Again, this means that directors must inform the Supervisory Board of their interest in the transaction and must abstain from voting. Furthermore, directors who are not independent must abstain from participating in the discussion and from voting on the issue. These members are not counted for the quorum. If all directors are either interested or non-independent, the decision to approve the related party transaction must be adopted by the GMS.

Mini-Cases 2 and 3:

2. The only shareholder of Company (B) is the brother of the Chairman of the Supervisory Board of Company (A). Company (A) sold its shares to Company (B) at a price that is below market. This is a related party transaction for Company (A). The Chairman of Company (A) is a related party and should not take part in decision-making on the approval of this transaction.

[523] LJSC, Article 83, Clause 2.

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

[525] LJSC, Article 83, Clause 2.

[526] LJSC, Article 83, Clause 3. The independence of directors during a related party transaction is not to be confused with independent directors as such. See Part II, Chapter 4, Section C.4 for a definition and discussion on independent directors.

3. Company (A) transferred a significant amount of assets to Company (C), in which companies (A) and (B) both receive shares: Company (A) receives 55% and Company (B) receives 45% without any consideration. The managers of Company (A) own Company (B).

   One year later, Company (A) sold 38% of its shares in Company (C) to Company (B) for the total price of U.S. $ 2,000. In reality, these shares were worth about U.S. $ 600 million.

   The sale of a 38% stake in Company (C) by Company (A) to Company (B) is a related party transaction and managers of Company (A) should not participate in decision-making on the approval of this transaction.

c) Required Information for the Decision to Approve Related Party Transactions

Depending on the nature of a related party transaction, either the GMS or the Supervisory Board must adopt a decision on the transaction. Regardless of which body approves, the decision must include information on:[527]

- The parties that are involved in the transaction;
- Other beneficiaries of the transaction (if any);
- The value of the transaction;
- The assets and services involved in the transaction; and
- Any other significant terms and conditions related to the transaction.

4. Identifying Related Party Transactions

Any related party transaction should be properly approved before it can be concluded. However, in practice not all transactions follow such procedures. There are different reasons for this, including the fact that the Supervisory Board and shareholders may not always know whether the transaction involves related parties, in particular when insiders concealed their affiliation and personal interest. In such cases, non-executive and independent directors will need to play the lead role in identifying and disclosing related party transactions. Creating the list of related parties and their position in the transaction is but one aspect, made difficult

[527] LJSC, Article 83, Clause 6.

by the fact that most ownership structures remain opaque. The materiality of these transactions is another important issue. Indeed, while the nature of some related party transactions is easily identifiable, others are structured in an elaborate manner, involving complicated off-shore schemes.

Best Practices: The Supervisory Board's composition and experience will largely determine the success in identifying such related party transactions. Non-executive, independent directors who enjoy an arms-length relationship with managers will certainly play a key role in this respect. The External Auditor also plays a key supporting role, and the Supervisory Board and its Audit Committee will want to ensure that the company's External Auditor uses the full range of audit procedures to evaluate managerial self-dealings. For example, the American Institute of Certified Public Accountants' (AICPA) Statement of Auditing Standard No. 45, AU Sec. 334 (2001) sets forth criteria for identifying material transactions, such as interest free borrowing, asset sales that diverge from appraisal value, in-kind transactions, and loans made without scheduled terms.

5. Disclosure Requirements

The Company Law requires persons who are potential related parties to disclose information to the Supervisory Board, the Revision Commission, and the External Auditor regarding:[528]

- Legal entities in which they, either independently or together with affiliated persons, own 20% or more of voting shares (participatory shares, units);
- Legal entities in which they hold managerial positions; and
- Pending or planned transactions in which they may be considered a related party.

Moreover, the disclosure of beneficial ownership is an important aspect in detecting related party transactions. If the identity of the company's true owners is hidden, then it is difficult, if not impossible, to establish whether the parties in the transaction are related (as mentioned in Section C.1.a of this Chapter).

[528] LJSC, Article 82.

Best Practices: To protect shareholder interests, the Supervisory Board members (especially independent directors) should demand that all owners of 5% and more of common shares comply with the relevant disclosure requirements.

➜ *For more information on the disclosure of beneficial ownership, see Part IV, Chapter 13, Section B.3.*

The FCSM addresses the issue of related party transactions and requires that companies include the following information regarding related party transactions in their annual report:[529]

- A list of related party transactions concluded by the company during the reporting year;
- Significant terms and conditions of each related party transaction; and
- The governing body that approved related party transactions.

In addition, securities legislation requires that companies disclose the following information on related party transactions:[530]

- Copies of the minutes of the meeting of the approving body, including information on the quorum and the voting results, for the registration of secured bond issue and the report on the results of issue;
- The list of persons, with whom transactions may be qualified as related party transactions, and the list of those persons with whom transactions have already been approved by the company, in case of an open subscription to securities;
- Information on related parties before the placement starts, in case of an open subscription through intermediaries; and
- The prospectus and quarterly reports must provide information on related party transactions.[531]

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[529] FCSM Regulation No. 17/ps on Additional Requirements to the Procedure of Preparation, Calling, and Conducting of the General Meeting of Shareholders, 31 May 2002, Section 3.6.

[530] FCSM Regulation No. 03-30/ps on the Standards of Security Issue and Registration of Security Prospectuses, 18 June 2003, Sections 2.4.7, 2.5.3, 6.4.7, 6.5.1; Annex 9 of the Standards, Section 11.

[531] Annex 4 of FCSM Regulation No. 03-32/ps on the Disclosure of Information by Issuers of Securities, 2 June 2003, Section VII; Annex 11 of FCSM Regulation No. 03-32/ps, Section VI.

Finally, accounting legislation requires companies to disclose information on operations with related parties in their accounting documents.[532]

6. Invalidation of Related Party Transactions

A court may nullify a related party transaction in a legal action filed by the company or a shareholder if procedural requirements were violated.[533]

Best Practices: Russian legislation seems to fall short in protecting the interests of the company's counterparts in related party transactions. If the company can seek to invalidate a transaction that was not concluded in accordance with its internal approval procedures then this may create undue problems for the counterpart. It is recommended to follow the example of some western jurisdictions where the company needs to prove that the counterpart in the transaction knew or must have known of the irregularity of its approval.

7. Liability for the Violation of Procedural Requirements

Related parties can be held liable for losses caused to the company because of a transaction that was concluded in violation of procedural requirements. If several persons are held responsible for losses, they are jointly and severally liable.[534]

Best Practices: A company may wish to codify its policy regarding related party transactions in its company-level corporate governance code, charter, or by-laws. More importantly, the company may codify a director's duty of care to properly handle related party transactions, i.e. not to authorize, procure, or permit the company to enter into a transaction if he has an interest in the transaction and has not disclosed this interest.

[532] Ministry of Finance Decree No. 5n, on the Approval of Rules on Accounting, "Information on Affiliated Persons," Rules on Accounting 11/2000, Section 5.

[533] LJSC, Article 84, Clause 1.

[534] LJSC, Article 84, Clause 2.

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