Chapter 11

Corporate Governance **Implications** of **Corporate Securities**

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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.

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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.

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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.

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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.

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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.

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- **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.

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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

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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.

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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.

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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.

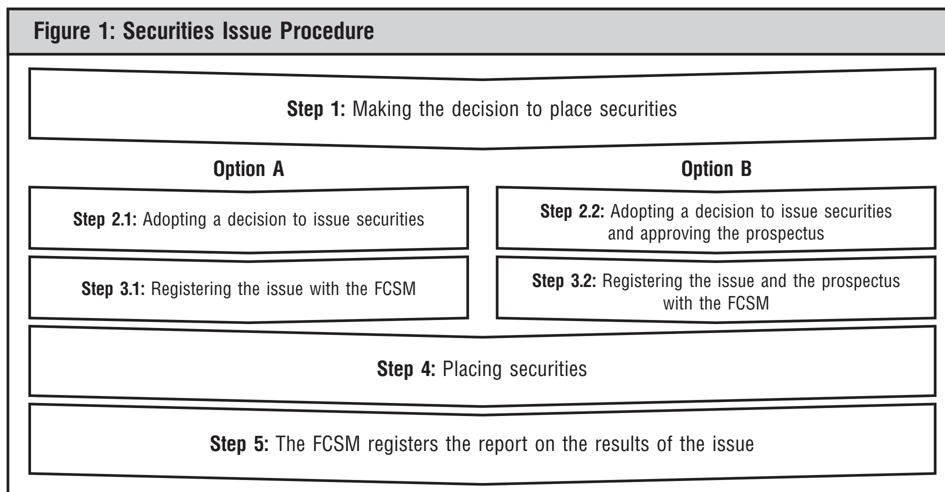
[403] According to Article 2 of the Law on the Securities Market, a securities market financial consultant is a legal entity licensed to carry out broker's and/or dealer's activity in the securities market and/or perform services in relation to preparing the securities prospectus of an issuing company. 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.

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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.

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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.

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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.

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.

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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.

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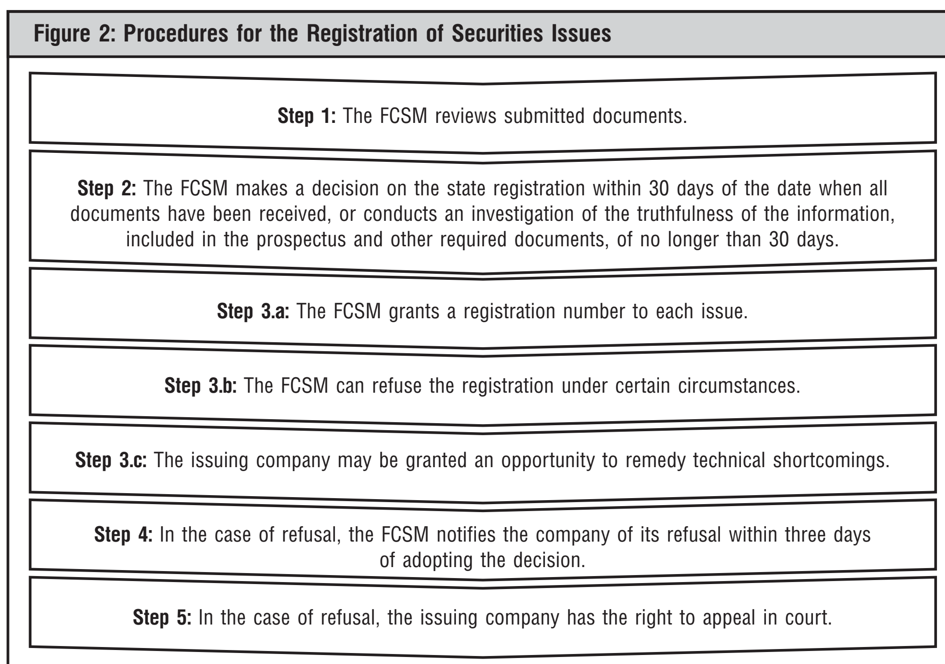
FCSM control over securities issue procedures extends beyond the registration of the issue and prospectus. If it discovers legal violations after registration, it can request that a court invalidate the issue.[432] The FCSM can deem that the issue was not undertaken in good faith in the case of violation 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



Source: IFC, March 2004

[432] FCSM Regulation No. 03-30/ps, Section 2.6.13.

[433] Law on the Securities Markets, Article 26.

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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.

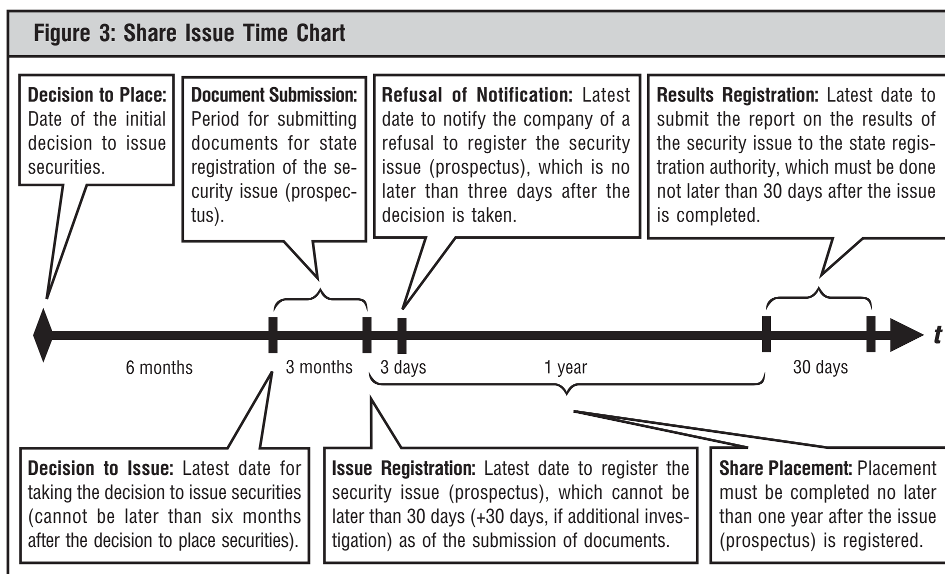
439 Law on the Securities Market, Article 24.

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).

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[440] LJSC, Article 36, Clause 1; Article 38, Clause 1.

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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.

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- 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

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[448] FCSM Regulation No. 03-30/ps, Section 5.3.1.

[449] LJSC, Article 74, Clause 2.

[450] LJSC, Article 74, Clause 1.

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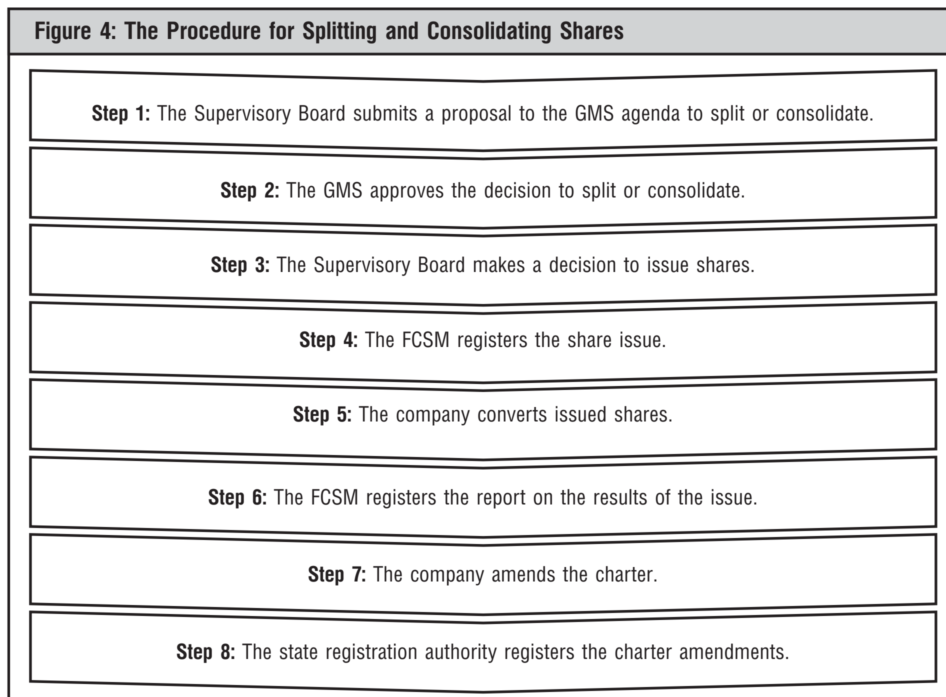
may be a psychological benefit in that shareholders own two (or more) shares for the price of one.[451]

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



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.

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[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.

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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]

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[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.

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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.

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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:

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[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.

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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.

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