

# MASTERARBEIT

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„Recent developments in Russian corporate governance:  
Is the new code the way forward? “

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## **Eidesstattliche Erklärung**

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I would like to thank my parents for their support during all the years of my study.

I would also like to thank Dr. Udo Braendle for his guidance, patience and support.  
Whithout him the writing of this thesis would not be possible.

*Quality management of companies has become as important for the Russian economy as quality control of Russia as a country. Having a strong corporate governance structure contributes to the formation of a favorable investment climate and promotes social progress.*

James Wolfensohn, 9th President of the World Bank (1995-2005)

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## Introduction

Ask a person from industrial country what he/she have heard about corporate governance in Russia and most likely you will face a surprised look followed by the question what corporate governance is. In the meantime CG has become one of the key issues in attracting international investors without even being noticed by some firms.

Establishment of market relations in Russia and increased role of joint-stock companies in the economic development of the state and welfare of the citizens made it necessary to understand the importance of the corporate governance problem, origin of which inevitably involves transition to a new management system. As a result of mass privatization, many companies unable to continue their activity and develop without attracting investments emerged on the market. Attracting investments is, in its turn, impossible without improving corporate governance.<sup>1</sup>

Russian managers and firm directors have started to realize the benefits of a good corporate governance structure. Interest towards international standards of corporate governance is growing both from issuers and government agencies, designed to ensure the rights of investors.<sup>2</sup>

Currently Russia is one of the leaders among transitional economies in terms of level of economic law comprehensiveness.<sup>3</sup> However, in issues concerning efficiency of these laws application the country lags behind even its “weak” neighbors.<sup>4</sup> Many foreign investors and entrepreneurs shudder when reading articles of Western journalists in Moscow about brutal wars inside Russian corporations. How true this information is and are there good reasons to believe in improvement of corporate governance in Russia?

Development and creation of corporate governance codes, standards of corporate governance, and principles of management bodies' activities, conducted by

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<sup>1</sup> Dolgopyatova T. (2004), 7

<sup>2</sup> <http://www.elitclub.ru>

<sup>3</sup> Preobragenskaya G.(2003), 1

<sup>4</sup> Kozarzevski P. (2007), 15

all kinds of participants of corporate governance system is one of the main courses for improvement of the institutional framework of corporate governance.<sup>5</sup>

The first Russian Code of Corporate Conduct was published in 2002 and have not been revised since then. A number of factors pointed out the necessity of a new regulating document, which resulted in creation of the first draft of the Russian Code of Corporate Governance. The major part of this thesis is devoted to the analyses of the old Code and its imperfections, as well as to the analyses of the Draft Code and its possible improvements. Another important part covers comparison of Brazilian Corporate Governance Code with Russian Draft Code of Corporate Governance, as well as comparison of CG in these countries in general, which lets us make some conclusions about the potential of the new Code and corporate governance in Russia as a whole.

The thesis is structured as following: after the short history of development of corporate governance in Russia a description of characteristics and features of CG is presented. Further, some theoretical issues including an outline of the OECD Principles of Corporate Governance 2004 are listed. After that the circumstances of creation of the first Russian Code of Corporate Conduct are described, followed by practical differences between the Code of 2002 and the Draft Code of 2013. Hereupon a more deep analyses of both codes starts with the description and analyses of weaknesses of the Russian Code of Corporate Conduct. Next Chapter covers features of the Russian Draft Code of Corporate Conduct, paying special attention to the structure and operation principles of the Board of Directors, issues of transparency and effective methods of minority shareholders rights protection. After the discussion of what changes should be done to the old Code and what still could be improved in the Draft Code, latest events in Russian corporate governance are reviewed. Further a comparison of corporate governance in Russia and Brazil is made and findings concerning perspectives of CG in Russia in comparison to CG in other developing countries are presented. A conclusion summarizing main issues and findings of the thesis completes the work.

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<sup>5</sup> <http://www.jourclub.ru>

## Corporate Governance in Russia

### Development of Corporate Governance in Russia

For proper investigation of the legal issues of corporate governance in Russia, understanding of previous corporate structure and legal rights of shareholders is essential.<sup>6</sup> For this purpose the main stages of the development of demand for corporate governance law in Russia are presented in table below:

Table 1: Main stages of the development of demand for corporate law in Russia

| Stage   | Characteristics  |
|---|--|
| Late 1980s – 1994: Emergence of demand for corporate law. | Development of legal institutions connected with the consolidation and re-distribution of rights on private property assets. Low regulatory potential, systemic gaps in the legal regulation of corporate relations, high conflict potential and lack of legal ways to solve conflicts within the business entities. Corporate law is viewed not as an instrument of attraction of investors into business but as an instrument of power redistribution and companies' takeover. Numerous conflicts on the stock market contributed to the growth of demand for legal regulation of corporate relationships. |
| 1995 – 2000: Improvement of the quality of corporate law. | Significant improvement in the quality of legal regulation of corporate relations due to the introduction of legislative basis for regulation of shareholder relations, creation of Federal Commission for the Securities Market (FCSM Russia) - a state system for stock market regulation,   |

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<sup>6</sup> Ikemoto et.al (2004), 2

|  |  |
|--|--|
|  | <p>consolidation of the system for registering rights on equity, emergence of norms aimed at protection of the interests in the stock market. Adoption of the first part of Russian Civil Code in 1994 and of the second part in 1996. Growth of demand for securing of property rights. Adoption of the Federal law on Joint Stock Companies in 1995 and the Federal law on Securities Market. However, corporate legislation had only a regulatory nature lacking sufficient legal sanctions in case of violation.</p> |
| <p>2000 – Present time: An integrated approach to the development of corporate law combined with enforcement mechanisms.</p> | <p>More integrated approach to regulation of corporate relations and improvement of the measures of compliance with legislation. New editions of the Russian Code on Administrative Violations and Russian Arbitration and Procedural Code, as well as the new Labor Code, based on market realities (unlike its forerunner from the Soviet time) and amendments on other laws were issued in 2002. New Chapters dealing with the crimes in the stock market were added to the Criminal Code.</p>                        |

Source: Based on Yakovlev A. (2004), 6-7; Redkin I. (2003), 8

Having learnt from the lessons of previous years, Russian legislation has improved sufficiently over the last decade; however, there is still a danger of “insiders” deals, deals with conflicts of interests and other fraud actions of directors,

so the Russian legislation system tries to go with the times permanently issuing new editions to existing laws.<sup>7</sup>

From the latest improvements having influence on Corporate Governance legislation in Russia, following documents can be marked out:

- Federal Law "On the Central Depository" (07.12.2011)
- Amendments to the Law "On the Securities Market" (29.12.2012)
- Amendments to the Law "On Joint Stock Companies" (19.04.2013)
- FFMS Order "On the approval of the Regime of the securities admission to organised trading" (30.07.2013)

According to Russian authorities, because of the adoption of these laws the situation in protection of share ownership rights has improved substantially, as well as in disclosure and information transparency of Russian companies and payments of dividends.<sup>8</sup> However, weak legislation system for corporate relations is not the main problem in Russia's Corporate Governance. In fact, Russian legislation for corporate relations is quite good developed in comparison to other emerging markets. The main problem where Russia lags behind even some CIS countries is law enforcement.

## Characteristics of Corporate Governance in Russia

Although the Russian model of corporate governance has similar features both with Anglo-Saxon and Continental models, it also differs from them, which makes it specific.<sup>9</sup> In the table below main stages of the development of corporate relations are described in order for us to follow the formation of the key features of CG in Russian Federation.

Table 2: Development of corporate relations in Russian Federation

| Stage (years) | Characteristics                      |
|---------------|--------------------------------------|
| 1991 - 1994   | Start of privatization, formation of |

<sup>7</sup> Redkin I.(2003), 8

<sup>8</sup> Russian Draft Code of Corporate Governance 2013

<sup>9</sup> Yakovlev A. (2004), 9

|                     |  |
|---------------------|--|
|                     | corporations as the primary basis of corporate relations.  |
| 1995 - 1998         | Formation of the national legislation and shift of emphasis in the regulatory framework from privatization to corporate laws.  |
| 1998 - 2004         | Completion of legislation formation, redistribution of property transactions, violations of law, growth and real influence of the stock market on corporate relations.   |
| 2004 – present time | Transition to state capitalism, intensification of the role of the state and its representatives in the corporate governance bodies, partial monopolization of the most profitable sectors in the national economy by state. |

Source: Dementieva (2009), 575

First of all, the key features of corporate governance in Russia include high concentration of ownership and leading role of majority shareholders in companies' management, with the state often being one of the largest shareholders.<sup>10</sup> Inconsistency in the development of CG in Russia, in terms of correspondence with a particular model, lies in the fact that practically the whole history of the Russian legal base formation followed the German (Continental) model; recent corporate practice and corporatization, however, have been actively developed in accordance with Anglo-Saxon tradition.<sup>11</sup> A growing number of Russian companies' IPO, including those launched on foreign financial markets, tells us that companies are focused on the stock markets, which makes Russian model of corporate governance similar to the models of countries with dispersed ownership.

Nowadays, however, principally big companies use services of financial markets, while many firms try to avoid new issues over fears of the management to

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<sup>10</sup> Dolgopyatova T. (2004), 46

<sup>11</sup> Kozarzewski P.(2007),14

lose corporate control. As independent studies show, higher levels of corporate governance practices can be observed in those Russian companies that have undertaken IPO and (or) are listed on the stock exchange.<sup>12</sup> Thus, in many cases exactly the need of attracting investments in foreign markets was the reason for creation and improvement of corporate governance.

Organization of the work of boards of directors in Russian companies also has similarities with one-tier board system of British and American firms. Boards of directors in Russia often include representatives of management in addition to external non-executive directors. Even though, according to the law on joint stock companies, members of the collegial executive body of the company cannot constitute more than 1/4 of the board of directors and the position of the CEO and the Chairman of the Board cannot be occupied by the same person, on practice it is compensated by the inclusion in the composition of the Board of those management representatives, who do not formally serve as members of the collegial executive body.<sup>13</sup>

There are different points of view concerning positive and negative factors of having a one-tier Board, but there is no argument that the board of directors with majority of the members being representatives of the management cannot exercise adequate quality control of the companies' management.<sup>14</sup> Thus, nowadays the formation of the Board from non-executive and executive directors is a feature of medium- and small-sized firms, while most of the large international companies have switched to two-tier board system.

## **Corporate Governance Code**

### **Theoretical issues**

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<sup>12</sup> <http://www.fcsm.ru>

<sup>13</sup> Yakovlev A. et.al (2004), 15

<sup>14</sup> Preobragenskaya G. et.al (2003), 4

Among the central goals of corporate governance are maximization of company's performance, minimization of the risk and protection of the interests of shareholders. Main advantages of the corporate governance are listed below:

Table 3: Benefits of Corporate Governance

| Benefits to society   | Benefits to Companies and Investors   |
|---|---|
| <ul style="list-style-type: none"> <li>• Encourages investment and sustainable growth</li> <li>• Fights corruption</li> <li>• Promotes competitiveness</li> <li>• Stimulates productivity and innovation</li> <li>• Promotes efficiency and reduces waste</li> <li>• Stabilizes financial markets</li> <li>• Fosters transparent relations between business and the state</li> <li>• Supports public confidence in the market system</li> </ul> | <ul style="list-style-type: none"> <li>• Enhances company performance</li> <li>• Lowers costs of capital</li> <li>• Strengthens company reputation</li> <li>• Improves strategy</li> <li>• Builds stakeholder relationships</li> <li>• Growth and preserves shareholder value</li> <li>• Protects investors' rights</li> <li>• Mitigates risk</li> <li>• Increases liquidity</li> </ul> |

Source: Krasniqi M., Bettcher K.E. (2008), 5

These goals can be achieved by means of internal and external discipline. In order to facilitate the decision making process of investors and standards' creation process of companies, as well as to prevent confusing differences between the standards in different countries, the Organization for Economic Co-Operation and Development (OECD) has laid out a set of basic principles designed to guide the functioning of CG in all the countries around the world.

First edition of the principles was published in 1999 and originally was meant to touch upon the subject of separate ownership and control within companies in order to assure responsibility of the management to shareholders. The document was revised in 2004 and included 2 additional issues, essential to emerging markets: Institutional Framework for markets and protection of minority shareholders.

An outline the OECD Principles of Corporate Governance 2004 is presented below<sup>15</sup>:

I. Ensuring the Basis for an Effective Corporate Governance Framework

The first principle was added to other following principles in year 2004 and it sets the important context for them.

- Transparent and efficient markets
- Rule of law
- Clear division of responsibilities among authorities

II. The Rights of Shareholders and Key Ownership Functions

- Secure ownership
- Information
- Participation
- Voting
- Share of profits

III. The Equitable Treatment of Shareholders

- Equal voting rights
- Protection of minority and foreign shareholders

Managers are being often controlled by majority shareholders, who put their own interests before the interests of the company and minority shareholders. Most frequently used mechanisms are related-party transactions and pyramid structures. In an effort to attract new investors and ensure sustainable growth of the firm, this problem must be solved.

- No insider trading or self-dealing

IV. The Role of Stakeholders in Corporate Governance

- Respect for legal rights and agreements
- Co-operation between corporations and stakeholders
- Access to information
- Communication and redress for violations

V. Disclosure and Transparency

- Timely and accurate disclosure of material information
- Disclosure of financial situation, performance, ownership, governance

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<sup>15</sup>Based on OECD Principles of Corporate Governance 2004; Krasniqi M., Bettcher K.E., 2008, pp. 5-6

- Accounting standards
- Audits of financial statements

#### VI. The Responsibilities of the Board

- Strategic guidance
- Monitoring of management
- Accountability to the company and shareholders
- Duty of care
- Duty of loyalty

The Code of Corporate Conduct is needed not only for investors but also for the whole business community and all entrepreneurs. Adoption of the Code means increased business transparency and, therefore, increased confidence of the largest potential partners. Adherence to the Code broadens prospects for any business and compliance with the Code by large number of companies raises a brand new outlook for the macro-economic development in general. For Russian companies development and implementation of the Code means the need to introduce new standards of transparency, changes in existing internal documents and development of new ones, as well as conversion of the board of directors into a real functioning body.

Managers have to rethink the mission of the Board of Directors, principles of its members' selection, qualification and professional standards of their activities, criteria and procedures for results evaluation as well as principles of the committees' formation. This is exactly what happened at the end of 20<sup>th</sup> - beginning of the 21<sup>st</sup> century. Owners and managers of Russian companies have started to realize that success in attracting investment depends not only on financial performance. The main barrier to the flow of investment now is the quality of corporate governance.

### **Russian Code of Corporate Conduct**

A whole range of investment and consulting companies operating in Russian market has started to promote a culture of corporate governance among Russian companies. They developed standards and codes, valuation methodologies, tried (and are still trying) to explain to the management of Russian companies the need of

corporate governance culture improvement. Some foreign investment companies assessing risks of investments in shares penalized Russian companies for the absence of a corporate governance code.<sup>16</sup> These actions worked.

Since the early 90<sup>s</sup> investors with the support of governments and international organizations (World Bank, European Bank for Reconstruction and Development, International Finance Corporation, the Organization for Economic Cooperation and Development, etc.) are actively campaigning for the development and implementation of rules that can protect rights of investors, especially minority ones, from various abuses by management and company's largest shareholders. In 1999, the Advisory Panel of business sector for Corporate Governance of Organization for Economic Cooperation and Development (OECD) formulated a set of basic principles, which were approved by the governments of countries - members of the OECD. Major international institutional investors (pension and investment funds) followed the example of OECD and engaged in the development of their own recommendations.<sup>17</sup>

As mentioned before, according to OECD, basic principles of corporate governance are the following<sup>18</sup>:

- I. Ensuring the Basis for an Effective Corporate Governance Framework<sup>19</sup>
- II. The Rights of Shareholders and Key Ownership Functions
- III. The Equitable Treatment of Shareholders
- IV. The Role of Stakeholders in Corporate Governance
- V. Disclosure and Transparency
- VI. The Responsibilities of the Board

There is no such a country that achieved 100% compliance with these principles. Closest results can be observed in developed countries, first of all in those belonging to Anglo-Saxon legal family (USA, Hong Kong, Canada). They are being followed by the countries of Civil law (continental Europe). Russia is among developing countries, for which the term Corporate Governance is still quite new and does not have a long history of its practice.

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<sup>16</sup> Экспертно-аналитический доклад «Практики корпоративного управления в России: определение границ национальной модели» (2011), 5

<sup>17</sup> <http://www.fcsм.ru>

<sup>18</sup> OECD Principles of Corporate Governance 1999

<sup>19</sup> OECD Principles of Corporate Governance 2004

OECD set the creation of corporate governance codes in emerging markets as its goal. As a result of cooperation between OECD and local institutions, by the end of 2002 international organizations, investors associations, governments of various countries and individual companies have adopted about 90 codes of corporate governance. One of them was Russian Code of Corporate Conduct, adopted on 5<sup>th</sup> April 2002.

It started in 2001, when Federal Commission for Securities Market proceeded with development of the Code of Conduct. Representatives of all major stakeholder groups - issuing companies, investors, representatives of the federal bodies of executive power, federal bodies of the legislative authority, companies- professional participants of the stock market, consulting companies, information and credit rating agencies and companies, expert centers, professional associations – were involved by the Russian Federal Commission for Securities Market in the process of improving of corporate governance in Russia and development of the Code of Corporate Governance. In order to create and ensure an existence of an atmosphere of views exchange between all interested parties for the development of the draft Code, Council on Corporate Governance was formed. Nearly 3 thousand issuers and 2 thousand professional securities market participants took part in the discussion about the text of the Code.

These discussions resulted in presentation of the Code of Corporate Conduct at the 4<sup>th</sup> meeting of the Council on Corporate Governance on April 4, 2002 and its further adoption the next day.

The final version of the Code of Conduct is a document that defines the ethical standards in the relationship between shareholders and the management of companies. The Code contains 10 chapters devoted to various aspects of the corporate relations regulation. It should be noted that this document was approved by the Government of the Russian Federation and was recommended for use in practice.

It does not come as a surprise that in countries with emerging markets codes tend to pay most of its attention to the basic principles of corporate governance (such as for example the fair treatment of shareholders, disclosure of information about the owners of the company, its financial performance, the procedure of Annual General

(Shareholders) Meeting. Structure of the Russian Code is quite similar to codes of other emerging economies, therefore it will not be examined here in detail. Instead, more scrutinized comparison with the new edition of the Code in order to follow the progress of corporate Governance in Russia over the last decade is performed.

#### Main Chapters of the Russian Code of Corporate Conduct 2002:

##### Introduction

1. Principles of Corporate Governance
2. General shareholders meeting
3. Board of directors of the company
4. Executive bodies of the company
5. Corporate secretary of the company
6. Major corporate actions
7. Disclosure of information about a company
8. Supervision of financial and business operations of the company
9. Dividends
10. Resolution of corporate conflicts<sup>20</sup>

Long time has the Russian Code of Corporate Conduct not been revised. Many things in the economy of the country have changed, but the development of the legal base for corporate government seemed to be frozen just like many other projects that were being talked a lot in the beginning and not heard of in the upshot.

In the following table we can see the development of some figures of economic performance during the last decade, among which positive change of nominal and real annual GDP Growth (except for the crises year 2009) and reduction of the rate of inflation can be noted.

Table 4: Statistics of economic performance

|                                   | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|-----------------------------------|------|------|------|------|------|------|------|------|------|------|
| <b>Nominal GDP, US \$ billion</b> | 432  | 589  | 763  | 989  | 1289 | 1671 | 1226 | 1480 | 1695 | 2053 |
| <b>Real annual GDP growth,%</b>   | 7.3  | 7.2  | 6.4  | 7.4  | 8.1  | 5.6  | -7.9 | 4.8  | 4.3  | 3.4  |

<sup>20</sup> Russian Code of the corporate Conduct 2002

|                                    |      |      |      |     |      |      |       |     |     |     |
|------------------------------------|------|------|------|-----|------|------|-------|-----|-----|-----|
| <b>Inflation, %</b>                | 12.0 | 11.7 | 10.9 | 9.0 | 11.9 | 13.4 | 8.8   | 7.0 | 6.1 | 5.7 |
| <b>Industrial output growth, %</b> | 7    | 7.3  | 4    | 6.3 | 6.0  | 2.1  | -10.9 | 5.5 | 4.7 | 2.6 |
| <b>Unemployment rate, %</b>        | 8.6  | 8.2  | 7.6  | 7.2 | 6.5  | 6.2  | 8.4   | 8.3 | 6.1 | 5.3 |

Source: Based on Ernst & Young, Doing Business in Russian Federation (2011), 54; Ernst & Young, Doing Business in Russian Federation (2013), 76

Thus, as we can see, the time does not stand still and for that meantime many companies have reached that level of development, where they have started to take corporate governance seriously.

The need for a new regulating document was mentioned by many firms, so, for example, "Inter RAO UES" (Russia's unique diversified energy holding) said the company has always used the Code of Conduct as an important source for the development of internal documents, but recently it did not keep up with the best standards of corporate practice. FFMS head Dmitry Pankin also named prerequisites for the preparation of a new edition of the Code: "The financial crisis of 2008-2009 has shifted the focus of corporate governance from issues related to the protection of shareholders' rights to securing the financial stability of the company, increasing the efficiency of the board of directors, establishment of an effective system of risk management and prevention of conflicts of interests, principles of remuneration policies"<sup>21</sup>.

In view of the mentioned above factors, FFMS has developed a project of a new corporate governance document which is meant to replace the old one from the year 2002.<sup>22</sup> The name of the code will be changed from "conduct" to "governance", which reflects the change in the approach and the role of the document.

### **Practical differences between the Codes of 2002 and 2013**

We start with one of the major CG problems in Russia – compliance with the code. Like in the previous code, provisions should be followed on a voluntary basis, which is questionable for developing country, where mandatory legal regulation is

<sup>21</sup> Газета "Коммерсантъ", №80 (5111), 15.05.2013

<sup>22</sup> <http://www.elitclub.ru>

taken much more seriously than self-regulation. Along with market forces and listing requirements it may work for big companies, trading their securities on international stock exchange, but by somewhat smaller companies it may be seen as a “green light” for further non-compliance.

Indeed, many large issuers have already declared their readiness to follow recommendations of the Code. For example (even though, according to investors, they pay more attention to corporate events than the normative theory), both biggest state-owned banks have declared readiness to change internal documents (the Code of Corporate Governance in the Savings Bank (SberBank) and the Code and Regulations - VTB), if required by the changing norms of the Code.<sup>23</sup> Besides, some provisions of the Code (for example those concerning independent directors) comply with the listing rules of the Moscow Stock Exchange. As soon as the new document is approved, the Stock Exchange will update listing requirements in accordance with provisions of the Code.

In the draft of the new Code considerable attention is given to the recommendations for the boards of directors, in particular, the criteria of independent director recognition are described in detail, a minimum share of such directors is recommended to be increased from 1/4 to 1/3. However, an increase to 1/2 of board members being independent directors could be recommended in situations with a large number of securities in free float.<sup>24</sup>

Also, the project recommends formation of separate committees for remuneration and nomination, which corresponds to international best practice. Moreover, it is recommended that these committees are chaired by independent non-executive directors. Audit committee, according to the Code, should be fully independent. However, it should be paid more attention to the role of the audit committee in overseeing risk management and internal controls (in particular concerning related party transactions, fraud and corruption).<sup>25</sup> Also, detailed and clear definition of nomination committee’s tasks is a positively seen improvement, but investors would appreciate even more if a necessity *for more formal and transparent*

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<sup>23</sup> Газета "Коммерсантъ", №80 (5111), 15.05.2013

<sup>24,16</sup> <http://www.blackrock.com>

<sup>25</sup> <https://www.icgn.org>

*processes for identification, selection, appointment and induction of executive and non-executive directors alike*<sup>26</sup> is paid more attention.

In comparison to the Code of Corporate Conduct 2002, the new Code gives its due to communication with shareholders, which is seen by investors as a means of protection and increase in shareholders' value. The next step would be direct directors' participation in communication with minority shareholders.

As for the content of the Code, it can be noted that overall language of the Code is very aspirational, which, taking into account voluntary character of compliance with the Code, gives rise to concerns about its effectiveness and implementation. Thus, it seems to make sense if some requirements would be introduced as mandatory for listed companies with further extension over all issuers in process of time.

What can really be seen negatively by investors, is that, although to big extent being used by companies participating in international listings, the new Code, just like the old one, does not say anything about the need for English language transactions to be published simultaneously alongside Russian texts.

Also, the language of the original version of the Code in Russian is not very "user friendly" and recommendations are scattered all over it. More structured list of key recommendations would make it easier for companies to follow it and for regulators and investors to monitor firms' compliance with the Code. It would also facilitate the evaluation procedure for proxy voting agencies, which reckon up the extent to which companies comply with provisions of corporate governance codes in different countries.<sup>27</sup>

Approximate content of the Russian Code of Corporate Governance 2013:

Introduction

Principles of Corporate Governance

1. Shareholder rights and equality
2. Board of directors
3. Executive bodies of the company

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<sup>17</sup> <http://www.mn.nl>

4. Corporate Secretary of the company
5. System of remuneration of directors, the executive bodies and other key management employees of the company
6. System of risk management and internal control
7. Disclosure of information about a company
8. Major Corporate Actions<sup>28</sup>

Thus, we can see that contents of the Codes slightly differ, but in most cases the new Code covers topics of the old Code under another title (e.g. Chapter 8 Dividends of the old Code is a part of Chapter 1 Shareholder rights and equality of the new Code), which is kind of confusing and makes it more difficult to find the information on the issue. In addition, the Code 2013 includes some new issues, such as different approaches to remuneration of directors and risk management, which were introduced owing to the recent crises and contain information about incentives for managers and measures to be taken in case of unfortunate events. Main additions (differences) to the Code 2013 in comparison with the Code 2002 that can be seen “with the naked eye” are gathered in the following table:

Table 5: Main issues of the old and new Corporate Governance Code

| Code Edition   |   |  |
|--|---|--|
| Main Issues  | 2002  | 2013   |
| General Shareholders Meeting (Shareholder rights and equality, 2013) | Shareholders have a right to participate in General Meeting   | Participation in General Meeting as a <i>fundamental right</i> of shareholders |
|  | Information about General Meeting min 20 days before it   | + electronic notification and information availability (via internet)          |
|  |   | Right to gather a meeting with <= 2% of voting shares                          |
|  |   | Prohibition of voting for "treasury" and "quasi-treasury" shares               |
|  | List of voting modes  | + electronic voting  |
|  | Warrant of Repeated Meeting in big companies (min 500 000 shareholders) with participants owing 20% voting shares (joint) |  |
|  |   | Clear dividend policy  |

<sup>28</sup> Russian Draft Code of Corporate Governance 2013

|                                    |  |   |
|------------------------------------|--|---|
| Board of Directors of the company  | Functions, duties and responsibilities of the board                | Clear definition of jurisdiction and functions of the board of directors in the articles of association and differentiation of the powers of the Board of Directors, executive bodies and the General Meeting of shareholders |
|                                    | Recommendation for independent directors and its definition        | More detailed and advanced criteria of independent director definition  |
|                                    | Description of possible committees                                 | Creation of committees is a <i>must</i> for effective functioning of the Board  |
|                                    | Equal Remuneration for all directors                               | Different approaches to remuneration  |
|                                    |  | Consideration of interests of such stakeholders as environment  |
|                                    |  | Establishment of <i>long term</i> oriented goals and perspectives   |
|                                    |  | Definition of approach for organization of risk management and external audit   |
| Executive Bodies of the company    | No directorship in other companies except for subsidiaries         | No record of directorship prohibition in other companies  |
|                                    |  | New issues: delegation of powers of the sole executive body to the managing organization  |
| Corporate Secretary of the company | Recommendation of introduction of the Corporate Secretary position | Corporate Secretary position as a necessity   |
|                                    | Duties of Corporate Secretary                                      | Definition of Corporate Secretary status  |
|                                    |  | Detailed description of Corporate Secretary functions   |
| Major Corporate Actions            | Major (big) transactions, reorganization, liquidation              | Listing and delisting of shares, company takeover, increase in the authorized capital of the company  |

|              |  |
|--------------|--|
| New Chapters | System of remuneration of directors, the executive bodies and other key management employees of the company (different approaches to remuneration) |
|              | System of risk management and internal control.  |

Source: Based on the Russian Code of Corporate Governance 2002, Russian Draft Code of Corporate Governance 2013

In general, the new Code is better adapted to international standards of corporate governance; it is more detailed and takes into account latest events in the world economy. The standards of the Code are still not obligatory for application, however, in contrast to the first Code, they are presented in such a manner that implies fulfillment of the standards by the companies or explanations of the reasons of non-implication (comply or explain basis).

Paying attention to “small” details listed in the Table above, it can be noted, that, in comparison to its forerunner, the new Code defines participation in General Meeting as a fundamental right of shareholders. Nothing special if compare to best practices, but for Russian realities where concentrated ownership prevails and minority shareholders rights are often disregarded, it is a step forward. Furthermore, the Code 2013 prohibits "treasury" and "quasi-treasury" shares voting, what used to be a frequent practice, and lowers the minimum threshold for gathering the shareholders meeting. Information progress seems to have reached Russian companies, as the new CG Code insists on electronic means of information disclosure as well as electronic voting opportunity.

As for the Board of directors, the CG Draft Code 2013 clearly defines jurisdiction and functions of the board of directors in the articles of association and differentiation of the powers of the Board of Directors, executive bodies and the General Meeting of shareholders. Existence of committees becomes a prerequisite for effective functioning of the Board. Interests of such stakeholders as environment come into play (what is really important especially for big multinational enterprises, since their actions are always under observation). In the old code they were mentioned, but not really considered. Neither did the Code of Corporate Conduct 2002 consider long term oriented goals and perspectives as not so much time passed since “wild 1990s” when every firm could only think about survival here and

now. The new Code takes into account current business environment and suggests long term oriented goals and organization of risk management. The system of remuneration of directors, executive bodies and other key management employees of the company is also revised in the new Code and, taking up the whole new chapter now, considers different approaches to remuneration.

The chapter on major corporate actions was increased by more detailed guidelines in each kind of action, paying a lot of attention to listing and delisting of shares and its redistribution. The position of Corporate Secretary acquires practical meaning and changes from the status of “accessories” of the companies’ corporate governance system to the guarantor of the minority shareholders right.

In addition to differences between two Codes that “lie on the surface”, opinion of the participants of the OECD Russia Corporate Governance Roundtable Technical Seminar that took place on 15 May 2013 in Moscow, that had a purpose of analyzing the draft of the new edition of Russian Corporate Governance Code and giving some guidance on its improvement is presented. Among participants of the Seminar were large international institutional investors, therefore their opinion is important and should not be ignored. Comments of these participants have been submitted to the OECD Russia Corporate Governance Roundtable in May 2013 in a background paper. Main issues of this paper are disclosed below, but before we start with them, let us have a closer look at the weaknesses of the Code of Corporate Conduct 2002, which will make it easier for us to see if the new Code contains improvements to the problem topics of the old document.

## **Weaknesses of the Russian Code of Corporate Conduct**

The main problem of still insufficient quality of corporate governance in Russian companies, including those listed on Moscow Stock Exchange, is formal compliance with many of corporate governance code’s provisions, that are of voluntary adoption character, and practical non-compliance or only partial compliance with the rules not directly prescribed by the law.<sup>29</sup> Moreover, in case of some serious corporate conflicts or shareholders rights violation, some issuers and companies try to use even such sort of opportunities, which are for sure a violation of legislation. This can

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<sup>29</sup> Kozarzewski P.(2007), 34

happen, for example, in case of imperfection of approaches to the interpretation of the rules in the current arbitration practice, lack of sanctions or technical issues, as it can make it difficult for regulating bodies and other shareholders to counteract violators.<sup>30</sup>

Participants of the Technical Seminar defined main problems of CG in Russia, dividing them into those directly broached by the current Code and general questions of legal regulation.

### Problems, directly touched upon in the Code

- Problem of reporting about compliance with the Code
- Disclosure of information for general shareholder's meetings
- Problems concerning activities of the board of directors
- Control over financial and economic activity
- Effectiveness and potential of Audit Committee<sup>31</sup>

#### *Problem of reporting about compliance with the Code*

The form of reporting is of recommendation character, which results in incompleteness and falsification of data about companies' compliance with Code's provisions. For example, issuers actively establish committees attached to the board of directors thus corresponding with the Code's regulations<sup>32</sup> (chapter 3, paragraph 4.7):

*One of the conditions for effective performance of its functions by the board of directors is the creation of standing committees....Considering the basic functions performed by the board of directors, it is advisable that the company's charter provide for a strategic planning committee, an audit committee, a human resources and remuneration committee, and a corporate conflicts resolution committee. The board of directors may establish other permanent or ad hoc (for resolution of specific matters)*

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<sup>30</sup> Kuznetsov A., Kuznetsova O., (2009), 453

<sup>31</sup> Shevchuk A. (2013), 3

<sup>32</sup> Shevchuk A. (2013), 5

*committees as it may deem necessary, in particular, a risk management committee and an ethics committee.*<sup>33</sup>

However, on practice some committees do not exist and their powers are not passed to operating committees. This can have negative impact on effectiveness of the Board's decisions concerning some important for the company and its shareholders issues. According to Russian Boards Survey 2012 made by PWC, only 39% of respondents mentioned clear division of responsibilities for analysis and monitoring of key risks between the board of directors and its committees<sup>34</sup>, which can point at limited role of committees in risk management.

Table 6: Board committees

|                 | Audit committee | Remuneration and nomination committee | Strategy committee | Ethics/Corporate Governance committee | Risk committee |
|-----------------|-----------------|---------------------------------------|--------------------|---------------------------------------|----------------|
| All (135)       | 98%             | 88%                                   | 43%                | 13%                                   | 8%             |
| LSE, HK (61)    | 97%             | 92%                                   | 33%                | 15%                                   | 12%            |
| NYSE/NASDAQ (5) | 100%            | 100%                                  | 40%                | 80%                                   | 0              |

Source: Based on the Survey by the Deloitte CIS Center for Corporate Governance (2012), 14

According to the Table 4, 98,5% of the companies from the sample of Deloitte survey have Audit committee on the Board level, which is close to European average of 98% (survey by Heidrick and Struggles, 2011). Visible improvement from 76% in 2006 (S&P survey) to 86% in 2008 (survey by Independent Director Association) and finally to 98,5% in 2012 could be noticed.<sup>35</sup> 100% of S&P 500 companies is rather predictable and does not require discussion, unlike results for Remuneration and Nomination committee and Strategy committee, which confirms indicated problem.

This problem influences the right of shareholders for receiving accurate information about the state of corporate governance, as well as the confidence in the system of corporate reporting as a whole.<sup>36</sup> Main reasons for incomplete compliance with the Code's recommendations are institutional regulatory weakness, non-binding nature of committees and low level of responsibility for providing false information.

<sup>33</sup> Russian Code of Corporate Conduct 2002, 5

<sup>34</sup> Russian Boards Survey 2012, 22

<sup>35</sup> Survey by the Deloitte CIS Center for Corporate Governance (2012), 14

<sup>36</sup> Kwak B. et.al, Journal of Accounting and Economics 54 (2012), 20

Thus, reinforcing reporting requirements of compliance with the Code, including creditability of reporting, as well as reinforcing requirements for creation and actual functioning of the committees attached to the board of directors can be advised for inclusion in the new document.

*Disclosure of information for general shareholder's meetings*

The main point of the problem is that shareholders of Russian companies do not have secured by legislation and the Code possibility to receive quality materials for shareholders' meetings in the most convenient for shareholders form in comfortable for them time constraints. Many listed companies announce the date of the ledger closing on the date of its closure. The problem is of major importance especially for foreign shareholders, who are practically being prevented from execution of their right to vote on the general meetings at the level, allowing studying all the materials and making a reasonable decision. Companies often disclose information about forthcoming shareholders meeting strictly in accordance with mandatory requirements of current legislation, but these requirements are not sufficient for international investors.<sup>37</sup> Even the notice of 20 days before the meeting does not allow international investors to vote in absentia, having a reasonable position on every matter of the day's agenda, since they may have a long chain of depositories, each of whom also has its internal voting deadlines. The main reason for weak practical shareholder rights protection is compliance by firms with only minimal requirements of legislation on information disclosure. Good example here is Chapter 2, paragraph 1.1.1:

*The law provides that, except in specific circumstances, notice of the general shareholders meeting must be given not later than 20 days before the meeting. Considering the importance of giving timely notice of a general shareholders meeting to shareholders, it is recommended that a company give a 30-day notice of each meeting, unless otherwise provided in the law.<sup>38</sup>*

Companies follow only the minimal requirements, secured by law (20-day notice), own initiations (30-day notice) are rarely seen. 10% of the companies having

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<sup>37</sup> McGee R.W.(2009),12

<sup>38</sup> Russian Code of Corporate Conduct 2002, 11

listing “A” (sample of 40 companies) do not provide information about the meeting by means of the internet. Around 12.5% of the companies are ready to publish the information about the meeting on their official web-pages not later, than 30 days before the date of the event. Others do that on 20 days’ notice, while in practice there are even cases with 14 days’ notice. About 40% of the “A” listing companies announce the date of the ledger closing on the date of its closure.<sup>39</sup> Thus shareholders are deprived of opportunity to get prepared to shareholders meeting and make their decision on voting by the moment of participants’ list availability. Besides, if meeting’s agenda includes the issue of dividends payment, then, according to the legislation, the date of the ledger closing is reflected in the market value of the shares and interests of shareholders in receiving dividend payments.<sup>40</sup> The Code of Corporate Conduct 2002 regulates the process of information disclosure about general shareholders meeting, but it gives recommendations on neither deadlines nor detailed description of the qualitative content of materials.

In view of mentioned above problem reinforced requirements to the volumes, timeframes, format and methods of disclosing information for shareholders at shareholders’ meetings, including information on ledger closure could be included in the Code of Corporate Governance 2013.

#### *Problems concerning activities of the board of directors*

*Efficient performance by the board of directors of its functions requires that some of its members are independent directors, i.e., persons who not only do not serve as members of the managerial board, but are also independent from the officers of the company and their affiliated persons and from major business partners of the company, and do not have any other relations with the company that may affect the independence of their opinions.*<sup>41</sup> (Chapter 3, paragraph 2.2, more detailed description of independent director criteria can be found in paragraph 2.3)

Now, it does not mean that all positions should be occupied by outsiders; on the contrary, insider directors with seasoned knowledge of companies’ business play an

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<sup>39</sup> Litvack K. (2013), 8

<sup>40</sup> Lazareva O. et.al (2009), 324

<sup>41</sup> Russian Code of Corporate Conduct 2002, 11

important role in the board of directors.<sup>42</sup> Unfortunately, in Russia insider directors often do not have required knowledge while independent directors with field-specific experience play rather formal role. Although the institute of independent directors in Russia is actively developing, corresponding changes to legislation are lacking. Criteria of independence do not correspond with international and best Russian practices. Independent director's rights and instruments of effective influence on the strategy of the Board are limited, which influences the effectiveness of the board of directors. Evaluation of the work of independent directors does not take place in practice or has a formal character.<sup>43</sup>

Currently, the role and place of the board of directors in the system of CG in Russia is being qualitatively redefined. Minority shareholders (portfolio investors) have also become more active in processes of votes consolidation for election of independent directors.<sup>44</sup> In 2008, driven by concern about the state of the CG in Russian companies, active development of the institute of independent directors was initiated by the President and Government of the Russian Federation. As a result, intensive replacement of civil servants by professional directors took place in companies with the state share of the equity. Despite this action, results of Deloitte latest research show rather modest improvement in the number of independent directors in state companies. Deloitte has compared results of 132 Russian companies as of August 1, 2012 with results of corrected values of Standard and Poor's results in 2006. A disappointing conclusion shows that in spite of the measures taken, the percentage of outside directors in state companies has increased only on 3% during last years (from 17% in 2006 to 20% in 2012).<sup>45</sup> Especially noticeable is the difference between state-owned and private companies, which can be explained by the presence of directors affiliated with the governance in the Boards:

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<sup>42</sup> Iwasaki I. (2013), 6

<sup>43</sup> Shevchuk A. (2013), 8

<sup>44</sup> Ivashkovskaya I., Stepanova A. (2011), 607

<sup>45</sup> Survey by the Deloitte CIS Center for Corporate Governance (2012), 11

Table 7: Board compositions broken down by ownership type

|                                      | State controlled<br>(39 companies; 30% of<br>the sample) | Privately-owned (94) |
|--------------------------------------|--|----------------------|
| Inside directors                     | 80%  | 62%                  |
| Representatives of all block holders | 70%  | 33%                  |
| Government representatives           | 60%  | -                    |
| Management                           | 10%  | 29%                  |
| Outside directors                    | 20%  | 38%                  |

Source: Based on Survey by the Deloitte CIS Center for Corporate Governance (2012), 11

Besides, there is no statistical data for Russian companies with regard to self-evaluation of Boards' effectiveness. At the same time, according to the results of the Russian boards survey made by PwC in 2012, 65% of respondents confirmed self-evaluation of their boards of directors. As a rule, it is conducted by the means of a special questionnaire (35% of respondents). Among participants of this survey 87% are non-executive directors, but due to the lack of the absolute values of the sample, estimation of the popularity of this trend is not possible.<sup>46</sup>

Not only evaluation of the effectiveness of the work of independent directors is missing, but also qualitative evaluation of the Board's effectiveness on the whole, which hinders the Board's members in increasing the productiveness of their activities. Lack of majority shareholders' hunger for endowment of all members of the board of directors with instruments of influence on decision-making process limits effectiveness of the strategic managerial body.

In order to solve the problem, establishment of uniform criteria on the independence of independent directors and mandatory performance evaluation of the board of directors, as well as mandatory reporting on conflicts of interests for members of the Board and voting regulations for such cases could be introduced.

#### *Control over financial and economic activity*

Internal control mechanisms can be very effective in disciplining the management when applied by independent company organ<sup>47</sup>:

<sup>46</sup> Russian Boards Survey, PwC (2012), 7

<sup>47</sup> Monks, Minow (2004)

*To ensure the control and audit service's independence from the executive bodies of the company in carrying out control over their activity, labor contracts with the head of the control and audit service should be concluded on behalf of the company by the chairman of the board of directors. Labor contracts with employees of the control and audit service should be concluded by company directors, preferably those heading the human resources and remuneration committee or the audit committee.*<sup>48</sup>

However, in reality the head of the controlling and auditing service and its workers are put under executive bodies' supervision, which hinders companies in executing independent and, therefore, the most effective model of internal control. Corporate practices and regulation systems of OECD and EU pay a lot of attention to this issue, because it can create a significant problem for existing shareholders and potential investors.<sup>49</sup>

In 20% of A-listed companies audit and control service submits directly to the Chairman of the Board.<sup>50</sup> In other companies functional accountability to the audit committee or to the board of directors and administrative submission to the head of the executive body of the company is provided. On practice partial submission puts additional requirements to the chief of the company unit in regard to his/her independency from executive bodies and ability to fulfill his/her duties impartially, including in relation to control of activities of executive bodies themselves.<sup>51</sup>

In case of strong influence of the management on the board of directors, executive body can subjugate the internal control organ directly to itself. And all this without breaking any laws, because when implementing the practice of partial conjugation, executive body refers to the Employment Code of the Russian Federation, according to which labour relations belong to company's executive body's prerogative.<sup>52</sup>

Most effective independency of inside control officials would be guaranteed if their assignment to a position and dismissal are carried out directly by the Board. In case there exists quorum for independent directors (3 and more), assignment and

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<sup>48</sup> Russian Code of Corporate Conduct 2002, 11

<sup>49</sup> Shevchuk A. (2013), 9

<sup>50</sup> Litvack K. (2013), 14

<sup>51</sup> Kuznetsov A., Kuznetsova O. (2009), 451

<sup>52</sup> Employment Code of the Russian Federation (2001), 32

dismissal of inside control officials should be performed by a qualified quorum of independent directors.<sup>53</sup> This modification would require changes to the Employment Code. For the start this exception could be introduced only for companies listed on Stock Exchange.

Consequently, measures for securing of practical independence and effectiveness of the company's internal control system, including by means of the powers of the Board, committees and independent directors should be implemented along with changes to the Employment Code (the latter applies to JSC listed on Russian and international stock markets).

#### *Effectiveness and potential of the Audit Board*

Paragraph 3.1 of the chapter 8 specifies the purpose of the audit committee:

*The procedures for the audit commission of the company should provide for efficiency of the mechanism of supervision of the financial and business operations of the company.*<sup>54</sup>

The essence of the problem concerning this chapter is that on practice audit board often has a formal nature. Federal law "on joint-stock companies" sets no limits to competence of this special control body and lets shareholders of the company decide on issues of this committee's competence. Moreover, no other controlling body has similar power in terms of calling a general shareholders' meeting and making inspections at any time.

According to the study of the Russian Institute of Directors (2011, sample 150 companies), 43% of all companies and 31% of listed ones have a practice of the audit board members not holding office in the company's management or being company's employee. At the same time there are no researches on the issue of the presence of independent experts and minority shareholders representatives in the audit board. Simple analysis of the audit boards' remuneration system in most A-listed Russian companies confirms formality of the audit board's nature.<sup>55</sup>

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<sup>53</sup> Braga-Alves M.V., Morey M. (2012), 1423

<sup>54</sup> Russian Code of Corporate Conduct 2002, 83

<sup>55</sup> Litvack K.(2013), 15

Companies disclose information about revision committee's activities extremely rarely. Usually the work of the committee comes to preparing a conclusion based on audit results of financial and economic activity of the firm over an accounting year for annual general shareholders' meeting. Although, it should be noticed that in Russian practice there exist companies with very effective audit committees. They make a few audits during the year, the results of which support the board of directors in making decisions about the General Directors of companies.

As a consequence of this problem shareholders are deprived of effective internal control body. Major shareholders abandon the use of committees' full potential, while minority shareholders lose the possibility to elect their representative for its membership, as the candidates are elected by a simple majority of votes.

In view of this problem, increasing effectiveness of Audit committee, including by creating a regulatory support for its members to be elected by cumulative voting could be advised.

### **Problems, not directly touched upon in the Code**

Apart from the weaknesses of the Code, directly related to its text, there are also some problems, not directly touched upon in the Code of Corporate Conduct, that influence the equality of CG and decisions of potential investors:

- Mandatory tender offer when buying 30% and more of the shares
- Fulfillment of obligations by the entities, acquired 95% and more shares of the company, to buy out the shares of remaining shareholders at a fair price
- Participation of "quasi-treasury" shares in the decision-making process during general shareholders' meeting
- Approval of related party and large-scale transactions in accordance with the best corporate governance practices

- Control of parental company over activities and transactions of subsidiary and dependent companies<sup>56</sup>

*Mandatory tender offer when buying 30% and more of the shares*

This problem includes 3 following issues:

1. Absence of mandatory tender offer for institutions, buying 30% and more of the share capital in case of indirect acquisition
2. Absence of mandatory tender offer for institutions that have obtained the right to use the shares or establish control over management, but not the right to own the shares
3. Lack of understanding about the responsibilities towards the mandatory offer in the case of share holding reduction below the statutory threshold of 30%, 50% or 75% of shares after the initial acquisition, but before the expiration of mandatory offer date.

These 3 main questions along with some other issues of this problem have a significant influence on the rights and interests of shareholders, because of, for example, corporate control changes in case of indirect acquisition. Possible changes to business policy of the firm (which influences the profit of the company) and dividend policy can take place.<sup>57</sup>

According to the chapter 6, paragraph 2.3 of the Code,

*It is not recommended to relieve the entity taking over the company of the responsibility to offer to buy out shareholders' common stock (issuer's shares convertible into common stock).<sup>58</sup>*

Thus, the Code implies that shareholders should have reasonable guarantees to conduct a divestment based on fair prices and protecting their rights procedures, when the corporate control of the company is changed. Unfortunately, the problem of mandatory offers contains a lot of issues, which can only be regulated by the rules of law and corresponding jurisprudence.<sup>59</sup> At the same time the New Code of CG could

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<sup>56</sup> Shevchuk A. (2013), 3

<sup>57</sup> Litvack K. (2013), 16

<sup>58</sup> Russian Code of Corporate Conduct 2002, 61

<sup>59</sup> Djatej A.M. et.al (2009), 245

be expanded with the chapter on investor protection in the acquisition of control, which would include problematic issues.

In view of the described problem some changes to legislation are already being discussed, which created a new problem of delaying the process of examination and ratification of the new bill of FFMS (the progress have not been noticed since OECD Russian Corporate Governance Roundtable in October 2012).

*Fulfillment of obligations by the entities, acquired 95% and more shares of the company, to buy out the shares of remaining shareholders at a fair price.*

The problem refers again to the absence of obligations towards the tender offer in view of indirect acquisition (including acquisition of the parent company), as well as to usage of different mechanisms, allowing underestimation of the equitable price by making use of gaps in legislation (e.g., formation of artificial purchase price by transactions between the formally independent, but de facto concerted acting parties). This significantly influences the rights and interests of shareholders involved in squeeze-outs.<sup>60</sup>

Current legislation lacks the term “concerted action”, which makes it difficult to prove the affiliation between offshore companies.<sup>61</sup>

Discussed issue is not touched upon in the Code, and, although the problem does not fully belong to the introduction of the CG Code, it is advised that the new Code includes some provisions related to the topic and supported by the law. In general, the new bill of FFMS “On Joint-stock Companies” would allow the settlement of most relevant issues and synchronization of Russian and EU practices.<sup>62</sup>

Therefore, some changes to regulation should be made for effective protection of rights and interests of shareholders with respect to voluntary and forced redemption of company shares.

*Participation of “quasi-treasury” shares in the decision-making process during general shareholders’ meeting*

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<sup>60</sup> Shevchuk A. (2013), 17

<sup>61</sup> Kuznetsov M., Molotnikov A. (2012), 15

<sup>62</sup> <http://www.fcs.m.ru>

Involvement of controlled by the firm and its management legal entities that have company shares on their balance sheet in the voting at the general shareholders' meeting is a frequent practice in Russia. Quasi-treasury shares were used for voting and had a lot of influence on the decision making process. Nowadays a number of oil companies possess this kind of shares; the art of their use is not known. The reason for remaining possibility of quasi-treasury shares use is lack of corresponding norms in legislation, although there is a direct prohibition in legislation for treasury shares to exercise their rights.<sup>63</sup>

This problem is not breached by the Code directly. It can be solved by improvement of legislation with respect to the method of affiliated persons' (and groups of persons) recognition and direct prohibition of voting for such kind of shares on general shareholders meetings. The new Code could contain a general principle, according to which voting of shares that are under indirect control of the company is not allowed. For effective fulfillment of this principle, it should be reflected in legislation.<sup>64</sup>

Therefore, some changes to legislation for prohibition of "quasi-treasury" shares to take part in decision making process during General Shareholders' Meeting are expected in the closest future.

*Approval of related party and large-scale transactions in accordance with the best corporate governance practices*

The problem lies in defining the entities with interests in particular transaction. In particular, employees of subsidiary or parent companies (which own 20% of shares) should not be identified as disinterested parties.<sup>65</sup> In general, practice of Russian JSC shows that related party transactions are conducted in accordance with existing law, so that the main problem is not in non-compliance with legislation, but in the weak system of companies' corporate governance. For example, sometimes the board of directors is not aware of conflict of interests of an executive body official that

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<sup>63</sup> Chernykh L.(2008), 175

<sup>64</sup> Litvack K. (2013), 22

<sup>65</sup> Shevchuk A. (2013), 20

prepares the transaction, because this official has no obligation to inform the Board or an internal controller about the situation.<sup>66</sup>

As for approval of large-scale transactions, legislation requires its unanimous approval by the board of directors or redirection to the general shareholder's meeting.<sup>67</sup> Therefore, it is important to make sure that a director, approving the transaction, has no conflict of interests. There exists no such a rule at the moment.

In order to ease the problem, changes and additions to the regulations and recommendations of the Code on related party transactions and large-scale transactions in accordance with the best practices of corporate governance should be made.

#### *Control of parental company over activities and transactions of subsidiary and dependent companies*

Disclosure of information related to activities of subsidiary and dependent companies (important facts, key decisions of the board of directors, etc.) does not correspond with the volumes and quality of information disclosure of parent company (with the exception of (when required by law) IFRS), which makes this information inaccessible for minority shareholders of parent company.<sup>68</sup> Federal law "On Joint-Stock Companies" leaves decision on this issue at the discretion of the firm itself.<sup>69</sup>

Charters of many large companies in Russia lack information on direct powers of the board of directors with respect to control over the key decisions and transactions carried out by subsidiaries and dependent companies.

This practice does not correspond to OECD Principle of Corporate Governance 2004 and requirements, secured in EU recommendations and international practice.<sup>70</sup> Therefore, adoption of a set of measures through the stock exchange requirements and provisions of the Code for guaranteeing effective control by the parent company over activities and transactions of its subsidiaries and dependent companies is needed.

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<sup>66</sup> Lovyrev D. (2012), 5

<sup>67</sup> Federal Law "On Joint-Stock Companies" (2013), 13-25

<sup>68</sup> Litvack K. (2013), 25

<sup>69</sup> Federal Law "On Joint-Stock Companies" (2013), 7-8

<sup>70</sup> OECD Corporate Governance Principles 2004, chapter 4, 6

To summarize all said above about weaknesses of the Code of Corporate Conduct, that proves Russia's belonging to countries with rather low level of corporate governance, main issues to be worked on are listed below:

- Reinforcing reporting requirements of compliance with the Code, including creditability of reporting
- Reinforcing requirements for creation and actual functioning of the committees attached to the board of directors
- Reinforcing requirements to the volumes, timeframes, format and methods of disclosing information for shareholders at shareholders' meetings, including information on ledger closure
- Broadening and clarifying the rights and powers of independent directors with respect to the most important issues discussed by the board of directors in accordance with the best international practices
- Establishment of uniform criteria on the independence of independent directors
- Establishment of mandatory reporting on conflicts of interests for members of the Board and voting regulations for such cases
- Establishment of mandatory performance evaluation of the board of directors
- Securing of practical independence and effectiveness of the company's internal control system, including by means of the powers of the Board, committees and independent directors
- Increasing effectiveness of Audit committee, including by creating a regulatory support for its members to be elected by cumulative voting
- Making changes to regulation for effective protection of rights and interests of shareholders with respect to voluntary and forced redemption of company shares
- Making changes to regulation for prohibition of "quasi-treasury" shares to take part in decision making process during General Shareholders' Meeting
- Making changes and additions to the regulations and recommendations of the Code on related party transactions and large-scale transactions in accordance with the best practices of corporate governance

- Adoption of a set of measures through the stock exchange requirements and provisions of the Code for guaranteeing effective control by the parent company over activities and transactions of its subsidiaries and dependent companies<sup>71</sup>

## Features of Russian Draft Code of Corporate Governance 2013

As already mentioned, OECD Russia Corporate Governance Roundtable took place on May 15<sup>th</sup>, and its main purpose was to discuss the draft of the new Russian Code. Many comments to the text have been made, both positive and negative; many advices for Code's enhancement have been given by investors - participants of the meeting.

First of all, investors estimate the effort of Russian government to improve the position of the country in the international arena. However, in order to do so, the principles of good governance should be underpinned by effective laws and regulations.<sup>72</sup> In developing country like Russia the flexibility of "comply or explain" approach is not always an advantage. Investors rather see the need for a combination of firm rules to lift minimum standards, which can be complemented by the best-practice standards that are to be adopted by the firms over time.

On the whole, participants of the seminar cannot deny notable improvements of the new edition of the Code, but in many issues it sets indeed minimal standards below which many investors would have serious concerns. Thus, many recommendations are being seen as a good basis for legal and regulatory reform which is hopefully yet to come.<sup>73</sup>

The biggest concern of investors is, as expected, protection of interests and rights execution of minority shareholders. Other important issues that were paid most attention to are:

1. Structure and operation principles of Board of Directors

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<sup>71</sup> Shevchuk A. (2013), 27-28

<sup>72</sup> Litvack K. (2013), 5

<sup>73</sup> <http://www.oecd.org>

2. Transparency
3. Effective mechanisms of minority shareholders rights protection
4. Reporting on compliance with the Code<sup>74</sup>

## Structure and operation principles of Board of Directors

### *Candidates' nomination for the Board of Directors*

The purpose of Nomination Committee is described in paragraph 2.1.4.4.3. of the Code:

*The nominating committee helps the board of the director achieve a higher professional level and work more efficiently, by making recommendations in the course of proposing nominees to the board of directors.*<sup>75</sup>

Thus, the Code makes the role of the Nomination Committee more important, directly including in its mission the task of managing the process of candidates' nomination for the Board. Here ensuring independency of the Committee from major shareholders influence is very important.<sup>76</sup>

Another positive improvement of the Code, noticed by investors is inclusion in objectives of the Committee of an...

*.....interaction with the shareholders with a view to finding those who can be nominated to the board of directors. Such interaction should be aimed at forming the board of directors in such a way that it would be most suitable for the purpose and objectives of the company and should not be limited to largest shareholders only.*<sup>77</sup>

In particular, investors welcome direct call for *such interaction should not be limited to largest shareholders only.*

### *Independence of directors*

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<sup>74</sup> Litvack K. (2013), 3

<sup>75</sup> Russian Draft Code of Corporate Governance 2013, 32

<sup>76</sup> Mäntysaari, P. (2010), 253

<sup>77</sup> Russian Draft Code of Corporate Governance 2013, 33

Understanding of the fact that *the board of directors should enjoy the confidence of the shareholders; otherwise it will not be able to function efficiently*<sup>78</sup> is very important for the management of Russian companies. Taking into consideration the lack of clear and consistent definition of independency in current Russian legislation, it is strongly advised for the new Code to include the definition corresponding to best international practice. Thus, it is seen as a very positive improvement that the Code includes detailed description of the factors defining independency of directors (paragraph 2.1.3):

*...persons who are not executive directors and, in addition, who are independent of any officers of the company, its major shareholders, their affiliates, legal entities controlled by the company, and its major trading partners and who have no other relationships with the company which may affect their independence of judgment.*

*In determining specific requirements (criteria) to be met by an independent director, such directors should be presumed to be able to make objective and fair judgments, free from the influence of the company's executive bodies, any individual groups of its shareholders or other stakeholders.*<sup>79</sup>

Also very important is increased attention to detection and resolution of conflict of interests, as directors involved in it cannot be defined as independent. Setting the minimum number of independent directors to 1/3 of the board's members may increase the general level of independency of the Board, which will definitely be welcomed by potential investors.<sup>80</sup>

However, it should be noticed that in order to gain the trust of investors some practical evidence of increasing transparency and responsibility of Board's activities is needed. In this sense minimum number of independent directors at 33% is not good enough for companies with dispersed ownership, where this number should account to 50%.<sup>81</sup>

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<sup>78</sup> Russian Draft Code of Corporate Governance 2013, 20

<sup>79</sup> Russian Draft Code of Corporate Governance 2013, 21

<sup>80</sup> <http://www.fcsr.ru>

<sup>81</sup> Litvack K. (2013), 10

Risks caused by independency from cross-membership in committees (except for short mentioning of positions in remuneration committee) are not touched upon in the Code. The number of shares, above which the director is no longer seen as independent, is too high (5%).<sup>82</sup> It is recommended to decrease this parameter. Also, issues, concerning appointment by the government of directors not being executive members of the company should be specified in the Code, as this increases standards of independency.

#### *Committees of the Board of Directors*

Since most of the Russian companies have only the minimum set of committees – Audit, Nomination and Remuneration, and many companies have no committees at all, recommendation of the Code to create such committees and other permanent or temporary operating committees is seen as a positive step. Moreover, the Code also recommends for chairmen of these committees to be independent directors and the audit committee to be completely independent.<sup>83</sup> Nevertheless, it should not be forgotten that effectiveness of these committees depends on its quality, independency and personnel membership.

#### *Risk management and internal control systems*

The board of directors has to provide a proper level of supervision over the system of internal control of the company in financial, operational and reputational fields. Thus, provisions of paragraph 2.1.1 of the Code are seen as a good step forward, as they concern the interests not only of shareholders, but also of stakeholders:

*Board members should carry out their duties reasonably and in good faith, with due care and diligence, and solely in the interests of the company and of its shareholders in order to achieve sustainable and successful development of the company. In addition, the board should consider the interests of stakeholders, including employees, creditors, suppliers of the company, and people living in the territory in which the company operates. In this regard, the board of directors is recommended*

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<sup>82</sup> Russian Boards Survey 2013, PWC (2013), 11

<sup>83</sup> Russian Draft Code of Corporate Governance 2013, 25

*to take decisions in compliance with accepted environmental and social standards.*<sup>84</sup>

In addition to this provision, recommendation of the Ministry of Finance (2011) referring to disclosure of ecological information in financial report of the company can be noticed.<sup>85</sup>

#### *Board's supervision of controlled companies*

As it was noticed above in description of the weaknesses of the Corporate Governance Code 2002, effectiveness of the Board's activity is limited by its powers to supervise and make decisions only with regard to direct activities of the company, but not with regard to activities of controlled companies. Therefore, the Code should define the jurisdiction of the board of directors quite broadly, in order to enable the Board with authority to gain information and make decisions concerning activity of its subsidiaries.<sup>86</sup> The Code recognizes the problem and stimulates directors to request additional information and, which is very important, urges companies to fix the duty of the company's officers to provide the board members with such information in its internal documents (paragraph 2.1.1):

*The efficiency of work carried out by board members (especially non-executive directors and independent directors) largely depends on the form, timing and quality of information they receive.*

*The information that is periodically presented to board members by the executive bodies is not always sufficient to enable the board members to properly perform their duties.*

*In this regard, board members are encouraged to request additional information when such information is necessary to make an informed decision. The duty of the company's officers to provide the board members with such information should be set forth by the company's internal documents.*<sup>87</sup>

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<sup>84</sup> Russian Draft Code of Corporate Governance 2013, 13

<sup>85</sup> <http://www.fcsn.ru>

<sup>86</sup> Kuznetsov M., Molotnikov A. (2012), 10

<sup>87</sup> Russian Draft Code of Corporate Governance 2013, 14

### *Fiduciary obligations of the Board of Directors' members*

Russian legislation lacks a comprehensive definition of fiduciary obligation of the Board's members that includes responsibility to care for the company and be loyal to it. This concept, along with measures of its realization, is an essential component of the legal basis of the corporate accountability system. The Code touches upon this question in the paragraph 2.2.1:

*Board members should act in good faith and reasonably in the interest of the company and its shareholders on the basis of full information, with due care and diligence*<sup>88</sup>.

This provision corresponds to the basic concept of the fiduciary obligation provided by the current Russian legislation; however, it lacks in breadth and accuracy, thus limiting duties of directors to a narrow set of objective responsibilities and releasing them from an obligation to express an independent opinion.<sup>89</sup> Therefore, the Code should include a requirement for this concept to be secured by a contractual obligation, contained in the labour contract with director as a temporary measure, preparing the basis for a legal and regulatory reform.

### *Evaluation of the Board's activity and legal succession*

It is a positive improvement that evaluation of the work of each member of the Board is recommended. In this way shareholders can see who has devoted their effort to the company and who can be discharged for the next year:

*It is recommended that evaluation of the board of directors' work should include not only an assessment of its work in general, but also an assessment of work of its committees and each board member, including its chairman. Performance of the board chairman should be evaluated by the independent directors, with due account of opinions of all the board members*<sup>90</sup>.

Also, there is a recommendation for annual quality assessment of directors' work, stipulating for evaluation by an independent organization at least once every

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<sup>88</sup> Russian Draft Code of Corporate Governance 2013, 15

<sup>89</sup> Litvack K. (2013), 16

<sup>90</sup> Russian Draft Code of Corporate Governance 2013, 19

three years with possibility of self-evaluation during remaining years. Main results of assessments are to be presented to investors on an annual basis. These recommendations correspond with best international practice.<sup>91</sup>

Another positive recommendation of the Code, which helps shareholders in evaluating effectiveness of individual members of the Board, presupposes disclosing information about the number of meetings held and information concerning attendance by each director.

On the other hand, there is only minimum attention paid to the responsibility of the nomination committee to plan succession both of the Board's members and chief managers. The Code lacks any indication of ongoing training of directors as well. This problem is very important for Russia, as there could be found many non-competent directors on the Boards of the companies, especially in the beginning of Russian business formation. Now many firms replace these directors with qualified ones, e.g. government representatives are being replaced by skilled directors.<sup>92</sup> Therefore, introducing a recommendation for ongoing training of directors could contribute to the quality of corporate governance in Russian firms.

## Transparency

### *Disclosure of information about beneficial ownership*

It is a good improvement that the Code urges companies, when needed by investors, to disclose even such information that is not required by law, including information about controlled companies (paragraph 6.4):

*In order to enable the shareholders and investors to make informed decisions, the company should disclose all material information about its activities, even if publication of such information is not required by law. The company should disclose information not only about itself but also*

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<sup>91</sup> Green Paper 2011, 7

<sup>92</sup> Iwasaki, I.(2013), 12

*about any legal entities which are controlled by and are material to the company.*<sup>93</sup>

Boards of directors should take responsibility for disclosing information about all important transactions with related parties and for providing this information for examination and approbation by independent outside directors. This recommendation depends a lot on appointing properly qualified and independent outside directors.

Proposed provisions with regard to transactions with related parties on the “Novyj Rinok” are seen positively by investors, however, they warn about limited role of independent outside directors in proposed standard of the “Novyj Rinok”.<sup>94</sup>

Furthermore, the Code requires disclosure of information about transactions with related parties to be done in accordance with criteria set by IFRS, where the criteria of materiality for disclosure of the terms of the transaction is 1% (for comparison, Russian legislation sets this criteria to 2%)<sup>95</sup>. Also, the IFRS requires more detailed description of transactions, which is, according to the Code, to be disclosed for transactions with related parties. Reporting system corresponding with requirements of IFRS is a good improvement, but respective restrictions should be considered here as well.<sup>96</sup>

As a next positive comment it can be said that there is a direct call to disclose information about company’s equity structure concerning....

*.....information about possible or actual acquisition by certain shareholders of a degree of control disproportionate to their shareholdings in the share capital of the company, including on the basis of shareholder agreements or the existence of ordinary and preferred shares with different nominal values.*<sup>97</sup>

*Effective and consecutive disclosure of information*

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<sup>93</sup> Russian Draft Code of Corporate Governance 2013, 50

<sup>94</sup> Litvack K. (2013), 18

<sup>95</sup> <http://www.fcsm.ru>

<sup>96</sup> Survey by the Deloitte CIS Center for Corporate Governance (2012), 11

<sup>97</sup> Russian Draft Code of Corporate Governance 2013, 51

Yet after the adoption of the Russian Code of Corporate Conduct 2002 it was noticed by investors that there is no requirement for synchronous reporting disclosure, made in accordance with RAS and IFRS. Also, the information disclosed to investors is provided in most cases only in Russian language, which makes it difficult for international shareholders to gain the information on timely basis.<sup>98</sup> Unfortunately, there are no recommendations concerning disclosing information in English. This can be an obstacle to realization of Moscow's ambition of becoming an international financial center by 2020.<sup>99</sup>

Therefore, it is seen as a positive improvement that the paragraph 6.1 of the Code recommends synchronous disclosure of important information both in Russia and abroad, when the securities of the company are traded on foreign markets. Investors also support the idea of introduction in the Code of advanced guiding principles of relations with shareholders, which could be used for comparative analysis of companies.<sup>100</sup>

Investors welcome provisions of the Code that confirm the responsibility of the board of directors to treat all shareholders fairly:

*In cases where the decision of the board of directors may have different effects on different groups of shareholders, the board should treat all shareholders fairly.*<sup>101</sup>

Nevertheless, the Code does not say anything about difficulties faced by holders of depositary receipts, neither does it say anything about disproportionate access to information by shareholders owning 25% shares.<sup>102</sup> In light of the alarm referring to the fact that controlling shareholders may exert wrong influence upon directors and have privileged access to information, the following provision of the Code, concerning rights and actions of directors, is seen positively by investors (paragraph 2.1.4.2.):

*All the board members should have equal rights of access to the documents of the company and those of the legal entities controlled by the*

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<sup>98</sup> Kuznetsov M., Molotnikov A. (2012), 3

<sup>99</sup> Russian Institute of Directors (2011), 17

<sup>100</sup> Shevchuk A. (2013), 23

<sup>101</sup> Russian Draft Code of Corporate Governance 2013, 14

<sup>102</sup> Ernst & Young (2011), 20

*latter. It is recommended to presume that if any document requested by a board member contains confidential information, including trade secrets, this should not prevent such document from being provided to the board member. The board member to whom such information is provided shall be obliged to keep it confidential, and such duty should be set forth in the company's internal documents.*<sup>103</sup>

#### *Financial documents by IFRS*

In view of problems that may occur due to existence of dual accounting system, the requirement of the Code for consolidated financial statements to be prepared in accordance with IFRS is viewed positively, as it could shed some light to confusion caused by the dual accounting.

Unfortunately, the Code does not contain any information regarding requirements to provide financial statements, made in accordance with IFRS, for non-consolidated affiliates. The Code should urge the companies for voluntary bridging that gap, because ambiguity about discrepancies between RAS and IFRS can cause reduction of the size of dividends paid.<sup>104</sup>

#### *Remuneration*

Russian legislation does not empower the board of directors to supervise the policy of remuneration payment to executive bodies, which, as international practice shows, leads to a sharp increase in payments. Also, there is a considerable gap between developing global and Russian best practices for shareholders supervision of remuneration payments for managers.<sup>105</sup>

The Code contains recommendation for independent from major shareholders remuneration committee to be engaged in development of remuneration policy, which *must comply with the principles of transparency and accountability*<sup>106</sup> (paragraph 2.1.2.5). How this policy should be implemented, in view of the absence of any practical mechanism of supervision by shareholders, is not mentioned in the Code.

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<sup>103</sup> Russian Draft Code of Corporate Governance 2013, 27

<sup>104</sup> Lowyrev D. (2012), 7

<sup>105</sup> Reznikova A. (2012)

<sup>106</sup> Russian Draft Code of Corporate Governance 2013, 17

There are also some positive improvements, for example, recommendation to forbid hedging the Board's participation in the share capital of the company (paragraph 4.2 4.).

Also, a very good standard concerning full information disclosure about remuneration of executive bodies and key employees is being established. It includes fixed fee, short- and long-term motivation, severance pay, incentive motivations wrongfully obtained policies. Taking account of risks policy deserves special attention, as it states the need for adjustment of remuneration paying respect to risk management systems and increase in the price of share capital in a long-term perspective.<sup>107</sup>

### Effective methods of minority shareholders rights protection

When talking about minority shareholders rights protection by the Code, international investors concern following issues:

1. Equal rights for all shareholders
2. Additional means of shareholders' protection in controlled companies
3. Mandatory offer for shares redemption
4. Voting of shares, belonging to entities controlled by the issuer
5. Preemptive right <sup>108</sup>

Speaking of equal rights for all shareholders, it should be noted that shareholders owning more than 25% of shares have unlimited access to information. However, minority shareholders should also have access to all information, including about subsidiaries and related parties. All shares of the same type should provide for the identical rights.<sup>109</sup> Of course, the greater the shareholding of an individual, the more rights/power within the company he has.<sup>110</sup> This statement is obvious also in one of the countries with most advanced corporate governance practices – England.

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<sup>107</sup> Sharma R. (2013), 23

<sup>108</sup> Litvack K. (2013), 22

<sup>109</sup> Cox J.D. (1997), 624-625

<sup>110</sup> <http://www.shareholderrights.co.uk>

However, it mostly effects actions that can be undertaken by shareholders depending on the number of shares they own, while access to information is the right of all shareholders.

Main concerns of international investors, which could be solved by additional means of shareholders' protection in controlled companies, add up to a widespread of controlled entities' ownership structures. First of all for the reason that such structures are often associated with inequality of minority shareholders in comparison with major shareholders.<sup>111</sup> Therefore, the Code should include provisions calling for controlled companies to provide for additional means of protection of minority shareholders' rights and interests.

One of the positive issues about the new Code is that it clearly urges companies to follow its principles and not just to comply with the formal requirements of the law, as well as to fill in the gaps in legislation focusing, in particular, on important transactions involving controlled companies (Paragraph 7.4 of the Code).<sup>112</sup> According to the Code, the board of directors is to be a leading hand when deciding on validity and fairness of the transaction's price for minority shareholders.

Another positive issue concerns principles, related to delisting of shares. They require transparency for this action. According to the best case scenario, the buyer should send a voluntary buyout offer on fair conditions and should not allow a mandatory delisting.<sup>113</sup> The paragraph 7.1 of the Code includes another good recommendation: it prompts the boards to enlist the services of independent estimator for market price determination of the assets in case of big transition or transaction with related parties even when a legislative requirement for such an action is lacking.

As for voting of shares, belonging to entities controlled by the issuer, "Novij Rynok" proposes its prohibition. However, it would be good if the Code applies this provision to all companies regardless of their listing segments.

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<sup>111</sup> OECD (2012), 11

<sup>112</sup> Russian Draft Code of Corporate Governance 2013, 104

<sup>113</sup> Serve S. et.al (2012), 3

“Novij Rynok” also proposed a regulation, concerning preemptive right. It requires application of preemptive right to other types of shares.<sup>114</sup> Moreover, the Code includes some specific voluntary liabilities (based on the best practices) for blocking and controlling shareholders, so that obligations of other shareholders are clearly defined.

In general the Code consists of a number of recommendations, capable of lessening old and serious concerns of investors. If its provisions will lead to visible practical changes, it will be a positive step on the way to restore investors’ confidence.

To make a conclusion to the chapter “Features of the Russian Draft Code of Corporate Governance 2013”, some positive and negative comments on the Code are gathered below.

More particular positive comments on the Code are:

- The Draft Code covers all JSC
- Nomination committee discusses potential board members with all shareholders irrespective of number of shares own
- Detailed definition of board’s independency
- All committees should be chaired by independent directors, whereas audit committee should be fully independent
- The board has to “consider the interests of stakeholders, including employees, creditors, suppliers of the company and people living in the territory in which the company operates”<sup>115</sup>
- Companies have to provide additional information to board members when requested, which is considered to be a part of their formal written duties
- Annual evaluation of board’s effectiveness, which is to be carried out by an external party at least every 3 years. Disclosure of individual board members meeting attendance for measurement of their effectiveness
- The Code motivates companies (including affiliated ones) to disclose all material information even if not required by law

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<sup>114</sup> <http://www.fcsm.ru>

<sup>115</sup> Russian Draft Code of Corporate Governance 2013, 14

- Companies trading their securities on foreign markets should make domestic and international disclosure of material information simultaneously
- The Code requires disclosure of pay policies for executives and other managers and recommends majority-independent remuneration committee
- The Code sets out a substantial number of recommendations that seek to allay serious and longstanding investor concerns (e.g. provisions related to delisting of shares require transparency thus urging the buyer to make a voluntary offer on fair terms which prevents forced delisting)
- Explicit disapproval of multiple share structures, support for one share – one vote system, demand for new placements not to violate dividend rights

#### Criticism and recommendations on the Code:

- The minimum proportion of independent directors should be raised from 33% to 50%
- Audit committee must be composed of financially literate independent directors, whose function has to be explicitly separated from the function of revision commission
- Code's definition of financial literacy falls short of that normally regarded as necessary
- The role of whistleblower protection is underappreciated
- Appointment of the audit firm for IFRS financial statements should be approved by shareholders
- The code neglects clear guidance regarding the balance between audit and non-audit services
- No information about on-going board training and development in the Code
- Disclosure policy should be fair to all shareholders and continuous to all material developments
- The Code could issue a set of best-practice investor relations guidelines against which the companies could be benchmarked

- Disclosure of pay policy should apply beyond the board level and cover highest –paid executives; Say-on-Pay provision could be introduced.
- The Code should stimulate companies to introduce takeover regulations, especially mandatory tender offers and squeeze-outs, owing to the absence of these amendments in the JSC law
- Application of the Code on Comply or Explain basis is recommended

As we can see, the new document has a lot of improvements against the Code of 2002, however many things still have to be included into the new edition of the Code for Russia to fulfill its ambition about Moscow being a new international center by the year 2020. Less than 20% of listed companies fully comply with provisions of the Russian Code of Corporate Governance 2002 with no explicit reporting obligation and no sufficient power of the Exchange to verify reported information.<sup>116</sup> This cannot be found attractive by investors, therefore it is necessary for Russian listed companies to lift governance standards.

However, as it has already been mentioned before, market participants claim that high standards of corporate governance itself are not a determining factor for investors. In evaluating potential investments, institutional investors are paying attention to the practice of corporate governance. CEO of "Uralsib" Yuri Belonoschenko asserts that investors are more interested in the specific facts of corporate governance such as a change of the ownership or top management, composition of the board of directors. "When a company is just entering the market, investors scrutinize corporate governance practices, but in general for managing companies it is a secondary factor. When the financial or credit analysis of the issuer is being conducted, we are primarily interested in the financial statements,"<sup>117</sup> - said the head of the management company "Promsvyaz" Alexey Ishchenko. In Russia the standards of corporate Governance are becoming higher, but its implementation still remains a problem.

Nevertheless, "we are convinced that clear progress as outlined above, backed by credible evidence of change on the ground both by companies and by regulatory authorities, has the potential to mitigate the challenges inherent in Russia's heavily

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<sup>116</sup> Shevchuk A. (2013), 25

<sup>117</sup> Газета "Коммерсантъ", №80 (5111), 15.05.2013

state-dominated economy and, with time and consistent reform, can play a major role in attracting investment from international investors” – so the participants of the technical seminar of OECD Russia Corporate Governance Roundtable say.<sup>118</sup> The next meeting is to be scheduled in October and will address the key issues of compliance, monitoring and enforcement of the new Code provisions.<sup>119</sup>

For the new Russian Code of Corporate Governance to become an effective mechanism of best corporate practice formation and identified problems solving, some actions should be taken. Among them are:

- Introduction of changes to legislation and other regulating documents by supplementing provisions of the Code
- Changing the requirements concerning compliance with the Code by stock exchange for companies, included in quotation lists on different levels
- Adoption of voluntary commitments to comply with the Corporate Governance Code<sup>120</sup>

## Latest events

Currently existing Russian legislation has adopted a number of important measures to protect shareholders (although there is still lack of mandatory dividends and the right of minority shareholders to call off management’s decisions). In the first place corporate governance is regulated by the Civil Code of the Russian Federation; other documents regulating CG are federal law "On Joint Stock Companies", "On the Stock Market", "On protection of rights and legitimate interests of investors in Stock Markets", and last but not least, regulatory acts of the Federal Commission for the Stock Market and some departments. However, the main reason of Russia's problems - poor enforcement of legislation. Here Russian Federation seriously lags behind most other transition economies, including a number of CIS countries.<sup>121</sup>

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<sup>118</sup> Litvack K. (2013), 21

<sup>119</sup> <http://www.oecd.org>

<sup>120</sup> Shevchuk A. (2013), 27

<sup>121</sup> <http://www.vivakadry.com>

## National Report on Corporate Governance

Current state of corporate governance in Russia can be observed in National Report on Corporate Governance made by the National Council on Corporate Governance (whose participants are heads of major Russian issuing companies, investment companies, the federal government, etc.) annually since 2008. Most often discussed topics are risk management, internal audit, information transparency, rights and interests of all categories of investors and shareholders, improvement of the legal regulation of corporate relations, etc. As it can be seen the problems are long known and now management realizes that for successful development of companies these problems of corporate governance should be solved. Acceptance of the problem in itself is already a good sign, as this is the first step to its solution.

Main conclusion of the authors of National report 2012 is that the quality of corporate governance in Russia is still low. The most serious issue is still the difficulties associated with obtaining information on eventual owners of the company.<sup>122</sup>

Among central issues mentioned in the National Report on Corporate Governance 2012 are:

- Non-compliance with standards of corporate governance that is becoming a main risk for development of the Russian economy

As it has already been mentioned, the biggest problem of corporate governance in Russia is weak legal enforcement. Corporate governance practices in Russian companies are of non-systemic and non-comprehensive nature. The company implements only certain given practices from a model instead of using all available components of international best practice.<sup>123</sup>

In the west the need for stricter compliance with regulations became obvious after such corporate scandals as Enron case in 2001. Although companies with concentrated ownership like in Europe are less vulnerable to conflicts induced by management that affect rather companies with dispersed ownership like in USA, they

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<sup>122</sup> National Report on Corporate Governance (2012), 3

<sup>123</sup> Shkolnikov A. (2011)

are more exposed to such scandal as the appropriation of private benefits of control.<sup>124</sup> In Russia, for example, big state-owned companies ruin investment programs, thus preventing the government from carrying out consistent economic policy. Rude Violation of the legislation by some companies leads to discounted value of Russian stocks.<sup>125</sup>

- Dividends

Investor protection has always been a crucial issue in corporate governance. In many countries including Russian Federation expropriation of minority shareholders by majority shareholders is extensive. The risk of never collecting returns on investments is real.<sup>126</sup> Many companies are not so eager to pay dividends to shareholders or shareholders are left unhappy with the amount of dividends. The system of shareholder rights protection does not always function and those who are responsible for it do not always manage to do their job properly. Besides, independent directors are often being seen as consultants rather than a supervisory authority. Thus leads to “controlled” or “friendly” Boards of Directors.<sup>127</sup>

- The weak state of the legal environment and regulatory mechanisms of corporate management

Legal environment and external regulatory mechanisms are especially important in emerging economies where there is little hope for self-regulation. Moreover, the presence of an external governance mechanism enhances the strength between proportion of independent directors on the board and level of voluntary disclosure.<sup>128</sup> Considering growing amount of independent directors at the boards of Russian companies, stronger regulatory mechanisms could have a positive impact on voluntary disclosures, which is again one of the problems keeping international investors away from investing into Russian firms.

Despite the fact that the number of regulations concerning the problem were adopted by the authorities during the last years, the weak state of the legal

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<sup>124</sup> Coffee J.C. Jr (2005), 198

<sup>125</sup> National Report on Corporate Governance (2012), 6

<sup>126</sup> La Porta et al. (2000), 4

<sup>127</sup> National Report on Corporate Governance (2012), 7

<sup>128</sup> Cheng E.C.M, Courtenay S.M (2006), 262

environment and regulatory mechanisms of corporate management still create a discount that is being applied to all Russian issuers and even advanced companies cannot avoid the so called “country effect”. As a result many Russian companies have difficulties attracting investment capital and Russian economy as a whole has difficulties competing in the world market.<sup>129</sup>

## Russian Boards Survey

Importancy of the board of directors in the governance structure of large business corporations has been discussed by scholars yet in 1980s. It has been agreed that effective work of Board members is a key factor in company’s success.<sup>130</sup> Russia is a country with a large amount of state-owned enterprises that have problems both at operational and board level. Operational problems include inefficiency and rent extraction; at the board level there is a risk when the board concentrates on achieving political aims or maximizing the profit for individuals involved in governance and management instead of achieving maximum profit for the people living in the country.<sup>131</sup>

One of the reasons for this problem is that (although the situation is changing now) board members appointed by the state are not rare guests on the boards of directors. Very often these members do not have specific knowledge needed for qualitative fulfillment of their duties. And even though some studies show that significant government ownership is associated with increased disclosure,<sup>132</sup> a lot of things about governance structure in such companies should be done so that positive aspects of being a state-owned company outweigh negative ones.

Results of the Russian Boards Survey 2013 made by PWC show that most directors see the problem of qualified directors deficit. Moreover, the share of survey participants who think so has increased from 61% in 2012 to 70% in 2013, making this problem more relevant for Russian firms.

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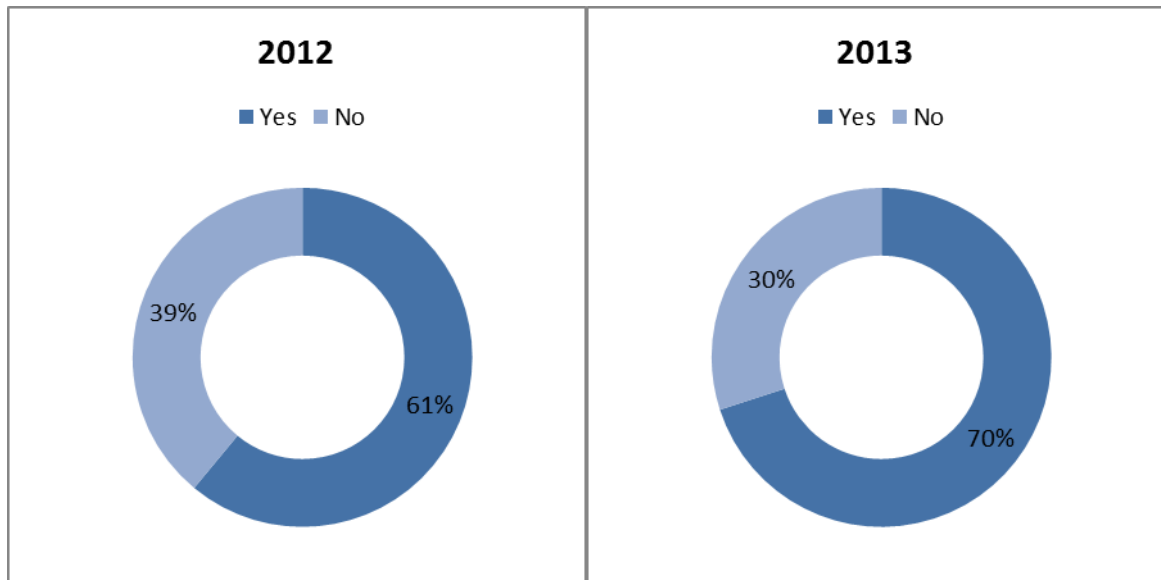
<sup>129</sup> National Report on Corporate Governance (2012), 8

<sup>130</sup> Baysinger B.D., Buttler H.N. (1985), 101

<sup>131</sup> Shkolnikov A. (2011)

<sup>132</sup> Eng L.L., Mak Y.T. (2003), 325

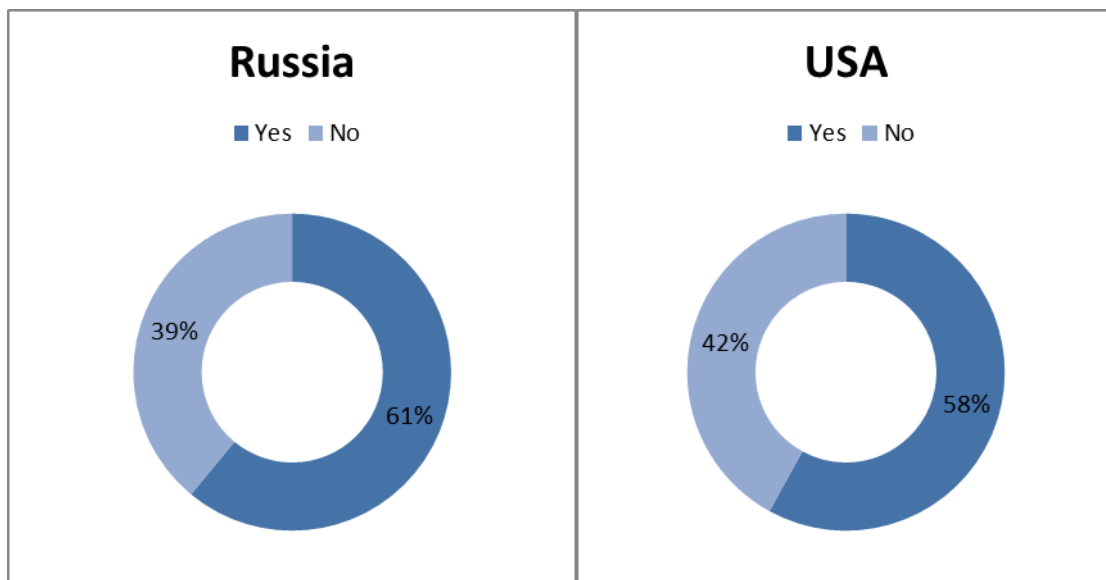
Figure 1: Shortage in qualified directors, Russia



Source: Based on the Russian Boards Survey 2013, 19

For comparison, the data of Russian and US surveys 2012 on this matter is presented below:

Figure 2: Shortage in qualified directors, Russia and US



Source: Based on the Russian Boards Survey 2012, 18

From the first glance the results of both surveys are similar, which should be a promising sign for Russian CG, however, the shortage of qualified directors in Russian and American firms has different patterns. In Russia boards of directors simply do not look for skilled professionals possessing necessary knowledge and

experience. As for those who do seek for qualified directors, many boards faced difficulties in finding specialist in such new (for Russia) fields as risk management, experience of working with international companies, marketing and even in some more common fields like finance.<sup>133</sup> Taking into account that the board represents shareholders in the company and is supposed to act in their interests, the issue becomes of crucial importance for investors interested in effective performance of the board, which, in its turn, is influenced by different factors including composition of the board and its quality.<sup>134</sup>

Another issue that became of importance is strategic planning. The table below summarizes strategy roles of boards identified in the literature and classifies them on what effect they will most possibly have on firm performance.<sup>135</sup> As it can be seen from the table, 2 out of 3 roles are most likely to have positive effect on firm performance, which is exactly what investors are interested in. Presence of the mid- to long-term strategy of the firm increases the chances of the company to attract investors, especially foreign ones.

Table 8: Effect of strategy roles of board of directors on firm performance

| Strategy Roles   | Effect on firm performance |         |          |
|--|----------------------------|---------|----------|
|  | Positive                   | Neutral | Negative |
| Framing objectives and vision of the business                | √                          |         |          |
| Formulating (with management) and reviewing company strategy | √                          |         |          |
| Setting tone at the top/ethical culture of the organization  |                            | √       |          |

Source: Based on Brennan N. (2006), 588

Composition of a strategic committee is crucial, because when the first strategic committees started to appear in Russian firms they often represented the first legitimate strategic bridge between company agents and owners. Before creating a strategy for the company, strengths and weaknesses of the company, as well as threats and opportunities are being analyzed by the committee and the board. The committee structure can be used as a means of communication between different

<sup>133</sup> Russian Boards Survey 2012, 18

<sup>134</sup> Brennan N. (2006), 579

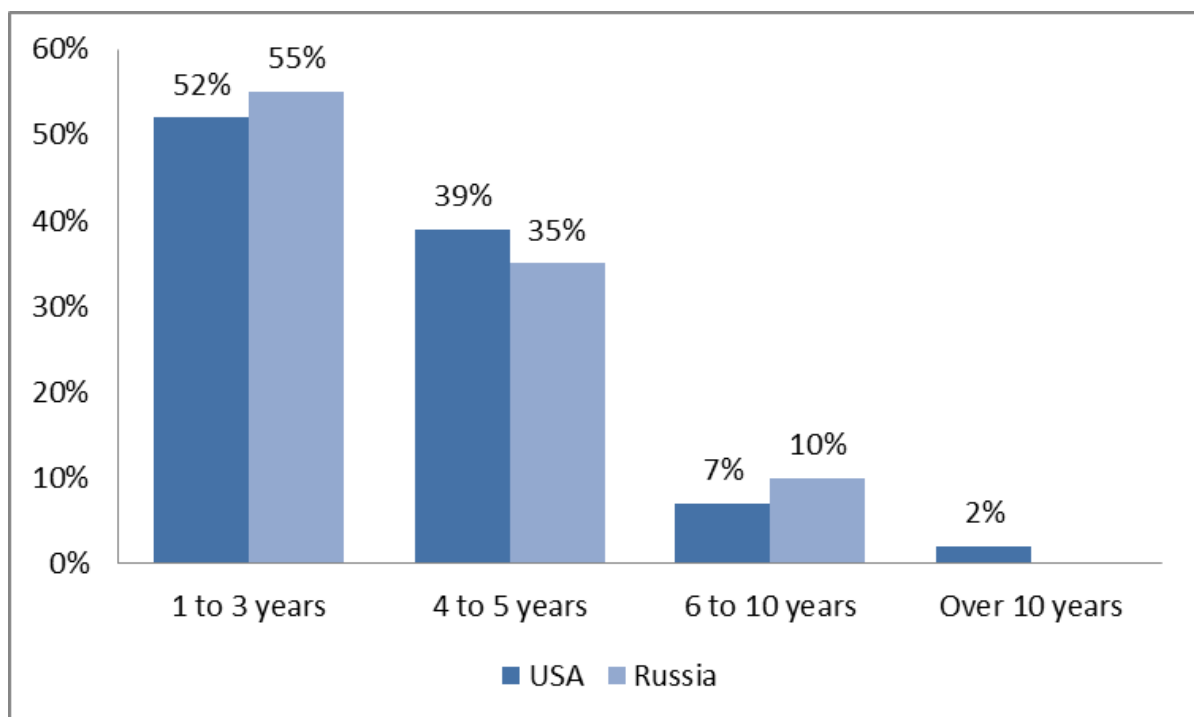
<sup>135</sup> Brennan N. (2006), 587

groups of shareholders. It also can make organizational boundaries between principals and agents more transparent.<sup>136</sup>

The fact that Russian boards of directors set varying time horizons for strategy development is a sign of maturity of the business; it shows that the time of property redistribution and fraud takeovers has passed so that companies can build long-term development strategies without being distracted by the threat to their existence.<sup>137</sup> Noteworthy is that responses of Russian directors are similar to responses of their US colleagues:

Figure 3: Time horizons for strategy development

(The respondents were allowed to select only one answer)



Source: Based on the Russian Boards Survey 2012, 7

However, if we look upon results of the respondents from the large companies (revenue over USD 5 billion), we can see a visible difference between Russian and US surveys. Most of Russian directors (67%) claim to use a period of 1 to 3 years when reviewing corporate strategies, while their American counterparts consider a longer horizon of 4 to 5 years.<sup>138</sup> Also, the relevance of the strategy in most Russian

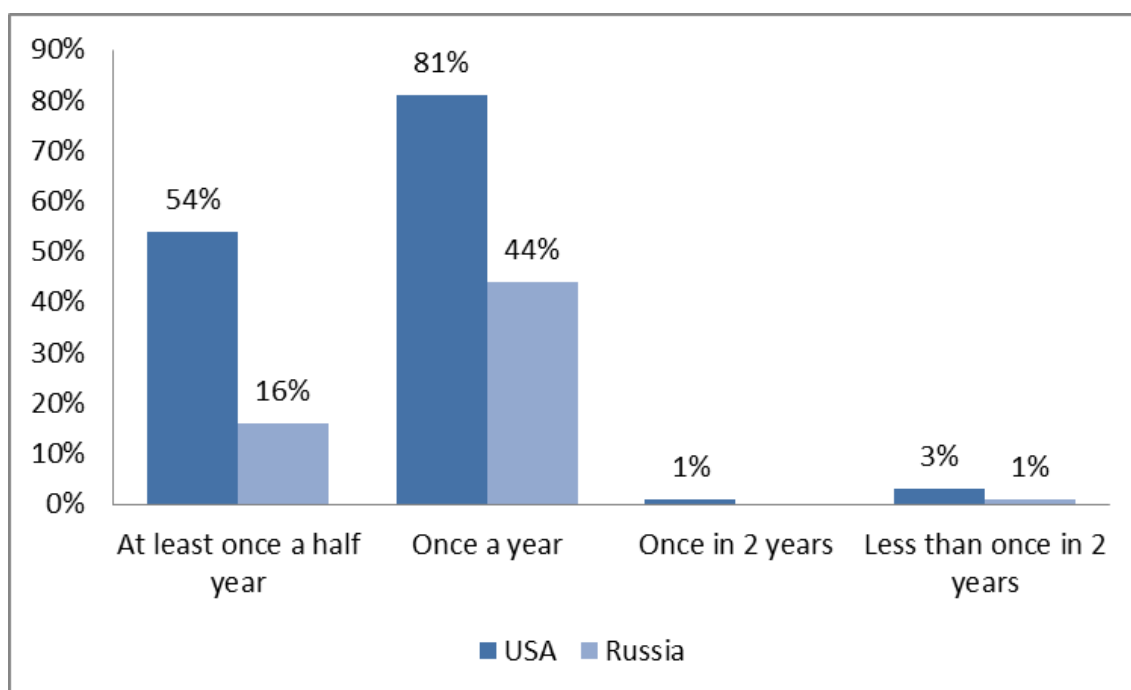
<sup>136</sup> McCarthy et al. (2004), 157-158

<sup>137</sup> Redkin I. (2003), 56

<sup>138</sup> Russian Boards Survey, 2012, 7

companies (81%) is discussed only once a year, while only 16% discuss their strategy every half a year (Figure 3).

Figure 4: Frequency of assessment of company's strategy viability



Source: Based on the Russian Boards Survey 2012, 8

Results of the Russian survey differ drastically from results of the US survey, where the majority of boards (54%) assess the relevance of the strategy at least every 6 months. These data emphasize the fact that USA belongs to countries with most developed corporate governance practices, while Russia is only on its way to achieve similar results.

### Crises and quality of Corporate Governance

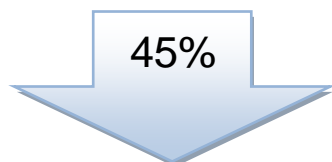
In countries where the protection of investor rights did not become a national priority, financial instability affects all companies regardless of their transparency level. Thus, during the crisis prices for stocks of Russian companies fell by about 17 percentage points lower than shares of foreign companies from wealthy countries.<sup>139</sup> Experts warn that in case of new financial shocks this situation could happen again, since there was no breakthrough in corporate law over the past three years.

<sup>139</sup> Reznikova (2012),15

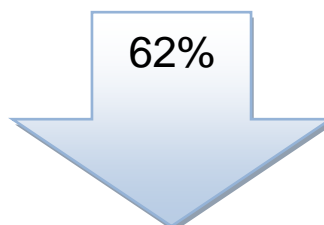
Having analyzed a sample of 843 companies from 38 countries, economists from NES (New Economic School, Russia) and the Institute for Advanced Study in Princeton have concluded that during the crisis in the countries with worse investor rights protection and greater corruption share price fell vastly.<sup>140</sup>

### How share prices fell during the crises

Country with investor's rights protection level like in Germany



Country with investor's rights protection level like in Russia



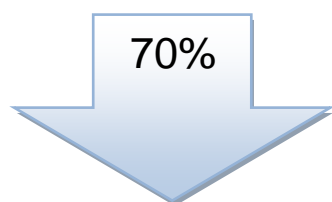
Source: NES, Institute for Advanced Study in Princeton

Consequently, the study shows that if a hypothetical medium-sized company with a level of corruption like in Germany fell by about 45%, the same company in a hypothetical country with the same characteristics, but with the level of corruption like in Russia fell by about 62%.

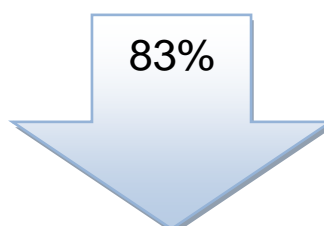
As for Russia, calculations show that the company with a high level of transparency fell on average by 70%, while the company with a low level of transparency by 83%.

### How share prices of companies with good and bad level of corporate governance fell during the crises in Russia

Companies with high level of information transparency



Companies with low level of information transparency



Source: NES, Institute for Advanced Study in Princeton

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<sup>140</sup> <http://www.nes.ru>

However, Prof. Sergej Stepanov (NES) notes that Russia here probably is a fortunate exception, because in countries with the same quality of management transparency did not have a statistically significant impact on the slump in shares. "In a strong legal environment corporate transparency during the crisis is becoming more important and contributes to significantly milder decline of the company shares,"<sup>141</sup> – so Prof. Stepanov says.

In a difficult economic situation the positive effect of good corporate governance is largely leveled, so the other factors come to the fore, first of all the ability of business to solve the financial problems quickly.<sup>142</sup> For example, many Russian companies deviated from the standards of corporate governance during the crisis, and as a result the owners, who had not participated in the operational management before, have taken the leading positions.<sup>143</sup> It shows us that information transparency during a crisis is important, but it is not the foundation upon which a company can avoid debt problems and get out of the difficult financial situation.

Most experts agree that situation with investors' rights protection have not changes over the past few years. Being yet the president of Russian Federation, Dmitry Medvedev gave some instructions aimed at improvement of the investment climate in the country in March 2011. Part of those instructions concerned improvement of corporate law; however, in reality initiatives aimed at improving the protection of shareholders rights have been virtually frozen because of development of new addition of Civil Code. Even though there were no significant legislative breakthroughs, Rostislav Kokorev (Deputy Director, Department of Innovation Development and Corporate Governance, Ministry of Economic Development of the Russian Federation) points to positive practice of court delays.<sup>144</sup>

Economic growth in Russia during last decade was based on the expansion of existing production capacity and increase in oil and other natural resources price. However, prices for natural resources are not stable and the use of existing capacity is approaching the limit.<sup>145</sup> Further economic growth could be secured by the flow of

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<sup>141</sup> <http://www.rbcdaily.ru>

<sup>142</sup> Kuznetsov M. (2013), 25

<sup>143</sup> <http://www.nccg.ru>

<sup>144</sup> <http://www.elitclub.ru>

<sup>145</sup> Pozharov A. (2013), 2

investments into the companies of non-oil sector, but low level of corporate governance is one of the obstacles to this process.

According to Nickolas Smithie (Global Emerging Markets Strategist at UBS Securities Co., Ltd), who discussed the code of corporate governance adopted in UBS, that assesses the state of affairs in all countries covered by the index of the stock markets of developing countries MSCI EM, Russia has a bad reputation. However, at the micro level the situation is better than it looks like. It is often very difficult to do business in Russia, but if the investor finds a decent Russian company, it will mean that the company is working really well, especially considering “difficulties they have to deal with”. Unfortunately, the reputation of being a country with low-quality business management is enough for Russian companies to be valued much lower than their competitors in other emerging markets.<sup>146</sup>

To sum up the arguments about influence of the crises on the quality of corporate governance, key points of the S&P’s report on governance infrastructure in Russia are presented below:

- The global financial crises exposed weaknesses in Russia’s governance regimes, particularly when several large investors exploited various legal loopholes to avoid mandatory buy-out bids
- These weaknesses have attracted criticism from international investors who have implemented the government’s attempt to build a global financial center in Moscow
- Since 2010 the governance has initiated several reforms of corporate governance in order to improve transparency of financial reporting and securities markets<sup>147</sup>

All in all, S&P believes that if government reforms are adopted and enforced, it would be a step forward in modernizing Russia’s CG infrastructure.

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<sup>146</sup> The Wall Street Journal, USA, 14.06.2011

<sup>147</sup> S&P (2011)

## Comparison of Corporate Governance in Russia with Corporate Governance in other countries

In order to decide if the state of corporate governance in Russia keeps up with modern international standards we have to review the latest tendencies in CG in leading international economies. This is not an easy task, since the current legal developments in corporate governance (including those on international, European and domestic levels) are extensive and difficult to follow. Most attention is paid to the issues of board remuneration, professionalism and composition of boards, including diversity, independence and freedom from conflicts of interest.<sup>148</sup>

After the De Larosiere Report (February 2009) on financial supervision in the EU, that identified corporate governance as one of the most important failures of the present crises, EU Commission started a review on CG with its so called Green paper 2010 (Green Paper on Corporate Governance and Remuneration policies for financial institutions). Although this paper was meant in the first line for financial institutions, half of the issues touched upon in the document were just as relevant for all listed companies.

A year later Green Paper 2011 (Green Paper on the EU CG Framework) for listed and (if desired) non-listed companies was published. Most important topics in the focus of the paper are: boards of directors, engagement of shareholders and “comply or explain” approach. Correspondence of the Russian Draft Code of Corporate Governance 2013 with the Green paper is presented in the table below:

**Table 9: Comparison of the Green Paper 2011 with Russian Draft Code of CG 2013**

| Issue                            | Criteria of the Green paper 2011 | Compliance of Russian Draft Code of CG 2013 |
|----------------------------------|----------------------------------|---|
| Board composition                | Professional diversity           | Yes   |
|                                  | International diversity          | No information                              |
|                                  | Gender diversity                 | No information                              |
| Availability and time commitment | Limited number of board mandates | Yes   |
| Board evaluation                 | Annual performance evaluation    | Yes   |
|                                  | External facilitator             | Yes, every 3 years                          |

<sup>148</sup> Clifford Chance (2012), 7

|                         |  |  |
|-------------------------|--|--|
|                         | Quality and confidentiality of information                     | Yes  |
| Directors' remuneration | Disclosure of remuneration policy                              | Yes  |
|                         | Shareholders' vote on the remuneration statement               | Yes  |
|                         | Independent functioning remuneration committee                 | Yes  |
| Risk management         | "Set from the top" policy                                      | No information   |
| Shareholders            | Conflicts of interests   | Yes  |
|                         | Proxi advisors' issues   | No information   |
|                         | Shareholder identification                                     | No information   |
|                         | Protection against potential abuse (for minority shareholders) | Not in all issues, e.g. reserved seats for minority shareholders in companies with dominant/controlling shareholder. |
|                         | Employee share ownership                                       | No such practice as in EU  |

Source: Based on the Green Paper 2011, Russian Draft Code of Corporate Governance 2013

From the table above we can see that the Russian Draft Code of Corporate Governance does comply only with the basic provisions of the Green Paper. When it comes to some more advanced requirements, there is either no information about it in the Code's draft or no such practice in the country. Therefore, Russian Draft Code does not keep up with the latest tendencies of corporate governance in developed countries.

After examination of the Russian Draft Code of Corporate Governance on compliance with provisions of the Green Paper (advanced corporate governance practices), we will also compare it with the code of one of the BRIC countries in order to have an understanding not only of how CG practices in Russia differ from that in developed countries, but also to define Russia's competitive ability against its rivals – developing economies.

In spite of differences between the history of corporate governance institutes, Brazil, Russia, India and China have a lot in common in benefits and infrastructure of regulating principles, which in many ways ensure their attractiveness for investors. Liberalization of government regulation and dynamic economic growth in biggest

developing countries predetermine their (BRIC countries) growing importance on international financial markets.<sup>149</sup>

One of the factors that hold back investment attractiveness of BRIC's companies is corporate governance risks, which is especially true for long-term investments in share capital.

Now, as we've chosen BRIC countries for our comparison, one of them has to be picked out for more detailed analysis of its CG (regulatory) system.

Analysis of national infrastructure of corporate governance is a starting point in CG risk evaluation of single companies. According to Standard and Poor's, analysis of country environment of corporate governance includes 4 elements:

- Market infrastructure
- Legal infrastructure
- Regulatory infrastructure
- Information infrastructure<sup>150</sup>

Thus, in conformity with Standard and Poor's, Russia has the most effective legal infrastructure of corporate governance among BRIC countries. However, its market infrastructure seems to be moderately effective because of the considerable participation of the state in the ownership and tightness in financial markets. Russia yields to India and Brazil in effectiveness of regulating structure, because CG regulation affects significantly only 22 out of 320 public companies in Russia in comparison to all 4985 companies in India and 97 out of 442 in Brazil (as of 2008)<sup>151</sup>. And finally, Russia is inferior to all BRIC countries in information infrastructure in view of disadvantages of accounting standards in Russia and belated change to IFRS (officially in 2012 for some group of companies, including listed ones<sup>152</sup>). For comparison, China introduced very similar to IFRS standards in 2007, India and

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<sup>149,55</sup> Коммерсантъ Business Guide №90 28.05.2008

<sup>150</sup> <http://www.standardandpoors.com>

<sup>152</sup> Federal law "On consolidated financial statements", 2010

Brazil use more advanced than in Russia standards and changed to IFRS in 2010 and 2011 correspondingly.

In addition, the latest version of the Code of Best Practice of Corporate Governance in Brazil was issued in 2009 (like in India), which is more recent then in Russia (2002) and China (2004).

For a visual comparison of the state of economy in BRIC countries some socio-economic characteristics of involved countries are presented in the table below:

Table 10: Selected Socio- Economic characteristics for BRIC countries

| Index   | Country |        |          |         |          |
|---|---------|--------|----------|---------|----------|
|   | Russia  | Brazil | China    | India   |          |
| Population (million), 2012, World Bank  | 143,5   | 198,7  | 1 350,7  | 1 236,7 |          |
| Number of listed domestic companies, 2012, World Bank   | 276     | 353    | 2 494    | 5 191   |          |
| GDP-PER CAPITA (PPP), 2012, World Bank  | 23 549  | 11 909 | 9 233    | 3 876   |          |
| GDP average growth rate (5 years, 2008-2012), World Bank  | 1,9     | 3,2    | 9,3      | 6,5     |          |
| Corruption perception index (scale 0-100; 0-highly corrupt, 176 countries sample), 2012, Transparency International | Score   | 28     | 43       | 39      | 36       |
|   | Rank    | 133    | 69       | 80      | 94       |
| Sovereign Credit Rating, 2012, Standard & Poor's  | Rating  | BBB    | BBB      | AA-     | BBB-     |
|   | Outlook | Stable | Negative | Stable  | Negative |

Source: Based on Wold Bank Data, Transparency International, Standard & Poor's

As it can be seen from the table, Russia cannot be compared with China and India in terms of population; also, there are a lot more listed companies in these countries. Moreover, GDP growth rate in Russian Federation decreases more rapid than in other 3 countries and have reached now the level of developed countries which, in case of Russia, is an evident sign of the start of stagnation. By the middle of 2013 economic growth has practically stood still, construction and industry are on the last year's level.<sup>153</sup> However, Russia's GDP-PER CAPITA (PPP) is still notably higher than in other countries. Russia also "wins" in the rating of corruption perception index,

<sup>153</sup> Forbes Russia, №8 (113), 2013, 24-25

which does not really attract new investments in the economy. The government concentrates on support of the state-owned companies, thus preventing establishment of entrepreneurial culture – the basis for a long-term growth.

After the analysis of socio-economic characteristics and national infrastructures of CG in BRIC countries, the choice for comparison of corporate governance codes fell on Brazil. First of all, the number of listed companies in Russia and Brazil are similar, both countries have lower average GDP growth rate than China and India and both have the same sovereign credit rating. Furthermore, according to Standard & Poor's, in terms of compliance with legal regulations, among other BRIC countries) investors feel themselves more comfortable in Brazil. Therefore the comparison with this country would be interesting, since in Russia the problem of poor enforcement of legislation is one of the most important ones.

While investors can feel themselves relatively safe, Brazil cannot cope with real's (BRL) strengthening, which causes the price increase. When the prices are so high (which is also the case for Russia), something must be wrong with the economy. According to comparison of accommodation prices in Four Seasons hotels (19 countries), most expensive rooms are in Moscow, second place belongs to Sao Paulo. In addition to problems with the national currency, the government started a lot of costly projects, which motivated the growth of expenses and taxes in Brazil.<sup>154</sup>

## Russia vs. Brazil

### *Russia*

Among other BRIC countries, Russia's legislation identifies the right of minority shareholders most widely owing to low ownership threshold, which allows nominating of candidates for the board of directors; annual re-election of the board of directors; and compulsory use of cumulative voting procedures. Changes to Russian legislation in the end of 1990s – beginning of 2000s eliminated normative deficit that made gross violations of minority shareholders rights in 1990s possible.

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<sup>154</sup>Forbes Russia, №8 (113), 2013, 12-14

However, among extant imperfections are late holding of annual meetings, long-term dividend payout, questionable independence of share registrars, as well as lack of obligation to disclose information about indirect ownership of share holding, which leads to risks of consolidated share holdings formations behind company's and minority shareholders' back.

### *Brazil*

An essential weakness of Brazilian law that regulates mechanisms of corporate governance is a high participation limit in the capital of non-voting preference shares with a floating dividend (up to 67%). This provokes the situation when considerable amount of shareholders receives an income dependent on performance of the company, while having paltry opportunities to participate in its management. Owners of preference shares have the right for conjoint election of only one member of the board of directors and one member of revision commission. At the same time, the only substantial financial compensation of preference shares owners is the right to receive dividends per share in amount of 110% of the dividends per common share. In Russia, for example, the usual ratio is 300%, although, as a general rule, this standard is secured in charters of companies and has no legislative support.<sup>155</sup>

Other weaknesses of Brazil law infrastructure applied to restrictions on proxy voting at general meetings and opportunity of companies to secure in the charter an exclusion of additional shares redemption from preferential right (e.g., by placement on Stock Exchange or by additional issue in an effort to merge with payment in shares). Obligatory offer in case of transfer of control in most cases did not apply to preference shareholders. The latest edition of the Code affects this situation.

Finally, judicial system is known for its inefficiency, especially with respect to joint-stock commercial conflicts.

The following table compares main issues of Russian and Brazilian Codes of Corporate Governance:

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<sup>155</sup> Borodina S., Shvirkov O. (2010), 57-58

Table 11: Comparison of Brazilian CG Code and Russian Draft Code of CG

| Issues                        |  | Russia  | Brazil   |
|-------------------------------|--|---|--|
| Ownership                     |  |   |  |
|                               | One share = one vote   | +   | +  |
| General Shareholders' Meeting |  |   |  |
|                               | Call notice  | Law -20 days;<br>Code - 30 days; (notification by mail, personal delivery, or publication of the notice)  | 30 days  |
|                               | Agenda and documentation   | Start of the registration of participants, where registration is conducted, and the person to whom shareholders may address their complaints                  | Minutes of listed companies  |
|                               | Availability of the participants list  | From at least 1% of votes   | Any shareholder  |
|                               | Quorum of reconvened general shareholders meeting in large joint stock companies | If shareholders holding on aggregate at least 20 % (30 % in law) of voting shares of the company take part in the meeting                                     | No information in the Code   |
|                               | Anti-takeover mechanisms   | Part of Major Actions chapter, along with reorganization and liquidation of the company   | +  |
|                               | Family council   | -   | +  |
|                               | Dividend policy  | Individual chapter, main issues: dividend amount determination, payment, consequences of incomplete or untimely payment along with transparency of procedures | Must contain, among other things: the frequency of payments, the benchmark used to define the amount; the process and the parties responsible for dividend payouts; the circumstances and factors that may affect a payout |
| Board of directors            |  |   |  |
|                               | Issues of corporate risk management, sustainability, spokesman policy            | -   | +  |

|  |  |  |   |
|--|--|--|---|
|  | Composition                                | Executive directors - max 25%; Directors must be in a possession of required knowledge, skills and experience                                      | Recommendation of formation exclusively by external and independent Directors. Clear list of skills and qualifications for the board membership |
|  | Number of members                          | -  | min 5, max 11   |
|  | Number of independent directors            | Min 33%  | Majority of members; number depend on the level of maturity of the organization, its life cycle, and its characteristics                        |
|  | Term of office                             | -  | Should not exceed 2 years, reelection is desirable; maximum number of years of continuous Board service should be defined                       |
|  | Serving on other boards and committees     | -  | Exact recommendations depending on the type of directorship   |
|  | Separation of Chairman and CEO roles       | -  | The CEO should not be a member of the Board, the CEO should attend the Board meetings as a guest  |
|  | Guests to Board meetings                   | -  | Occasional invitation of other organization officers, technical assistants, or consultants  |
|  | Committees                                 | Strategic planning, audit, human resources and remuneration, and a corporate conflicts resolution; <i>ad hoc</i> : e.g. risk management and ethics | Among others, audit, human resources/compensation, governance, finance, and sustainability  |
|  | Ombudsman and Reporting Channel            | -  | +   |
|  | Secretary of the Board of Directors        | +  | Including his/her functions responsibilities  |
|  | Documentation and preparation for meetings | Well in advance, detailed meeting minutes  | Minimum of 7 days in advance; meeting minutes   |

|  |   |   |  |
|--|---|---|--|
|  | Relationships with shareholders, the CEO, other officers, committees, the Fiscal Council and auditors | -   | +  |
|  | Remuneration  | Equal for all members   | -  |
|  | Liability of its members  | +   | -  |
| <b>Executive bodies</b>                        |   |   |  |
|  | Regular reporting   | Reporting to shareholders at the annual general shareholders meeting  | At least on the website on all aspects of firm's business activities                                     |
|  | International standards   | -   | +  |
|  | Internal controls   | +   | Should be reviewed at least once a year for effectiveness  |
|  | Transaction approval  | Equal or in excess of 5% - notice to the board of directors; equal or in excess of 10% - approval by the Board                    |  |
| <b>Corporate Secretary</b>                     |   | Individual chapter  |  |
| <b>Disclosure of information about company</b> |   | Information policy, forms of disclosure, insider information  |  |
| <b>Independent auditing</b>                    |   | +   | Approval by shareholders for rehiring after 5 years  |
| <b>Fiscal Council</b>                          |   | Mentioning only of internal control and audit service, acting independently of executive bodies, report to the board of directors | Separated from audit committee, internal audit and independent auditors, report directly to shareholders |

Source: Based on the Brazilian Code of Best Practice of Corporate Governance (4th edition), 2009; Russian Draft Code of Corporate Governance, 2013

In general, Brazilian CG code is better structured and more compact, any issue can be easily and promptly found, while Russian Code is not so easy to follow, the information is scattered all over the place with frequent paraphrasing of already given information. It pays a lot of attention to the issues of the board of directors, definition of independency, issues regarding managerial board, liability of board's members (both board of directors and managerial board), transparency of procedures and confidentiality of information. All in all issues that a country with an "entry level" of corporate governance has to cope with.

In this respect Brazilian Code of CG is more up to date than the Russian. It follows the changes in the Brazilian organizational environment, stresses the value of the best practices and adapts them to the new market demands and realities. First addition of the Code (1999), focused on the Board of Directors alone, and was revised in 2001 to include recommendations for other agents of corporate governance – such as shareholders, managers, auditors and the Fiscal Council. The document was revised again in 2004, with updated content adequate to the country's market demands at the time.<sup>156</sup> Looks like the issues, on which the Brazilian Code concentrated in 1999-2004, play the major role in the Draft of the Russian Code, which means that even issuing the new Code on Corporate Governance, Russia will be lagging behind the standards of CG in Brazil.

As it has already been said, according to Standard & Poor's, in terms of compliance with legal regulations, (among other BRIC countries) investors feel themselves more comfortable in Brazil. This might have something to do with the fact that Brazilian companies participate in US listings, which have more strict regulations. In other words, Brazilian companies have no choice but comply with legal regulations if they want to be listed on US Stock Exchange, which they do. So, probably, stricter listing requirements would also help Russian companies in lending creditability to investors. After all, Russia is a country that belongs to transition economies, where clear directives are of more use than general legal criteria – standards.<sup>157</sup>

After all the arguments and issues discussed, the main question: can the new Code improve the situation in corporate governance in Russia? - is to be answered. First of all, it cannot be said that the Code keeps up with the latest tendencies in corporate governance, it also may not correspond with all the issues of the code in developed countries and even lag behind some of its rivals (i.e., for example, Brazilian CG Code). However, every country has its own history of legal development as well as its own corporate governance environment. Thus, it makes mechanisms, successfully implemented in one economy less useful in another.

What we do know is that for Russian realities the new Code is a big improvement to the old one. Even though the Code 2002 is of a recommendatory character, many firms have significantly amended their internal documents in accordance with the Code's provisions. It also serves a reference for subjects of CG

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<sup>156</sup> Brazilian Code of Best Practice of Corporate Governance (4th edition, 2009), 13

<sup>157</sup> Braendle U., Kostyuk A. (2007), 19

systems and representatives of regulators, as well as rating agencies and investment companies. There can even be found examples of Code's use in court proceedings between shareholders and issuers.<sup>158</sup> Consequently, the new addition of the Code is a more advanced reference point for all participants of corporate governance system.

The awareness of compliance with the CG Code's benefits is growing in minds of owners and managers of Russian companies. There is evidence of voluntary compliance with international best practices of CG, described in companies' own codes of corporate governance (e.g. VTB's Code of Corporate Conduct), as the Russian Code of Corporate Conduct 2002 is out of date. The latest Russian Corporate Governance Roundtable meeting (22-23 October 2013 - Moscow, Russia) focused on issues related to implementation, monitoring and enforcement of the new Russian Corporate Governance Code.<sup>159</sup> It was attended by high-level Russian and international stakeholders, including, among others, public authorities, investors, issuer companies and stock exchanges. It shows us, that the problems are known and recognized as existing.

Furthermore, recognition of the problems by authorities lead to some legal changes in the last years, the most recent was amendments to listing requirements, which are related to codes of corporate governance Russia. In July 2013 FFMS published a new order on listing requirements, which includes consequences of non-compliance with it. Moscow Stock Exchange is planning to prepare its new listing requirements by the second quarter of 2014.<sup>160</sup>

Based on the listed above reasons, showing obvious progress and supported by the evidence of changes on the company and regulatory level, it can be said that this progress has a potential for eliminating the problems inherited from the Russian economy with strong involvement of the state. Moreover, after some time passed and a number of consecutive reforms are carried out, corporate governance can play an important role in attraction of international capital investments.

Of course there is a problem of legal enforcement in Russia, alone enforcement of strengthened regulations on ownership disclosure (7<sup>th</sup> April, 2011) may become an issue for a number of reasons. First of all, Russian history lacks cases of that kind of legal enforcement. Moreover, there is no certainty that FSFR will be able to cope with

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<sup>158</sup> Shevchuk A. (2013), 25

<sup>159</sup> <http://www.oecd.org>

<sup>160</sup> 2013 Russian Corporate Governance Roundtable, Agenda (2013), 4

a big number of violations. Also, the penalties for non-compliance with regulations are quite modest in comparison to those in developed countries (e.g. 35000\$ in Russia vs. 5 million \$ and/or 20 years of prison for individuals and 25 million \$ for companies (as of May 2011))<sup>161</sup>.

Experts say that Russia is “not interesting” in terms of its economic potential in comparison to some other developing countries, but maybe successful implementation of the corporate governance code, supported by legal rules, can change the situation? There is no better time to find that out than now.

## Conclusion

After the so-called "corpulent years", when the growth of the economy in Russia showed good figures, some tough times came - both economic growth and the dynamics of industrial production moved into a phase of stagnation. Though the government is trying to urgently improve the situation, making efforts to find quick and effective measures, it faces a lot of difficulties in obtaining its goal.<sup>162</sup> Moreover, most of the measures undertaken by the government are of a monetary character, which is not enough for a successful solution of the problem. Weaker ruble have been attracting investments for a long period of time, but this strategy cannot work forever, “cheap” investment will make no use for investors if they don't trust the company with its money. Besides, high inflation (and in Russia with average rate of 7%-8% for the country it reaches 20%-25% for poor part of population) destroys small and medium business. Therefore corporate governance becomes of importance now, when old measures of attracting capital into the country become outdated and fail to work.

Perhaps this is one of the reasons why the new edition of the Code is about to be issued exactly now, as this is very typical for Russia to do the things the usual way as long as it is possible. Only the impossibility of further exploitation of profitable resources can force the government and companies to invest into something new.

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<sup>161</sup> Standard & Poors Newsletter May 4, 2011

<sup>162</sup> Mironenko O. (2013)

The Code of Corporate Conduct 2002 introduced really the very basic principles of corporate governance. Nevertheless, only less than 20% of issuers, whose shares are traded on the stock exchange, fully comply with the requirements of the Code. It should be noticed, that these 20% issuers do not have clear stated obligations regarding reporting and supervisory mechanisms, while the stock exchange has only limited power to verify the information provided by the companies.<sup>163</sup> Another fact that is worth attention is that presently only 60% of the largest state owned enterprises have an audit committee.<sup>164</sup> Therefore improvements to the Code 2002 set probably very ambitious standards for companies, stock exchange and regulatory bodies. However, it is very important for Russian companies to improve the standards of corporate governance, otherwise there will be no reason for international investors to choose Russian market when there are other more attractive alternates available.

The new Code pays a lot of attention to disclosure of information, as this is one of the biggest worries of international investors. In fact, many deals in Russian companies are conducted through one-day firms. For example, in 2003 transactions of asset disposition through such companies accounted for 11.3% of Russia's GDP. In 2004 this figure rose to 13.1%. More recent studies have not been conducted, but experts have not noticed a downward trend.<sup>165</sup> For this reason, the requirements concerning disclosure of information have become more strict and particular. However, there is lack of any reference to disclosure of information in English language, which can be a real obstacle to realization of Moscow's ambitions to become an International Financial Centre by 2020.

Unfortunately, as good as the provisions of the new Code could be, the main problem remains to be poor enforcement of legislation, where Russia lags behind even its neighbors – CIS countries. As for Russia's closest rivals – BRIC countries – in terms of compliance with legal regulations investors feel themselves more comfortable in Brazil, although Russia has the most effective legal infrastructure of corporate governance among BRIC countries. The problem is that Russia's market infrastructure seems to be moderately effective because of the considerable participation of the state in the ownership and tightness in financial markets.

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<sup>163</sup> Litvack K. (2013), 27

<sup>164</sup> Litvack K. (2013), 10

<sup>165</sup> National Report on Corporate Governance, 5<sup>th</sup> issue, 2012

Moreover, Brazilian Code of Corporate Governance itself is more up to date than the Russian; it follows the changes in the Brazilian organizational environment, stresses the value of the best practices and adapts them to the new market demands and realities. There is, however, a positive tendency of understanding by the companies of the importance of the corporate governance in attracting investments, when the phase of redistribution of property is over and shareholders can focus on other issues. There is an evident prove of changes on the level of companies and regulatory bodies, and so there is potential for elimination of the problems, inherited by the Russian economy with strong involvement of the state.

IFRS has developed the strategy of financial market development for the period until 2020. Among its objectives are improvement of capital market infrastructure and regulatory environment, enhancement of norms and standards for investors' rights protection, making better the procedures of information disclosure and preventing unfair practice of doing business on the market. In process of the time, when logical reforms are carried out, the Code can play an important role in attracting capital international investments.

Originally, publication of the new Code of Corporate Governance was set to the summer 2013. However, it still was not enacted. On one hand it can be seen negatively, because Russia has been in need for a new document for some time now. On the other hand, a new edition of the Draft Code has been published, which includes some changes to the first draft suggested by experts and international investors. The fact that regulating organs pay attention to remarks made by international investors makes us believe that they understand all the importance of corporate governance for Russian firms and want to make it properly this time. This is indeed a good sign for the future of Russian corporate governance.

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## Appendix

### Abstract

The practice of joint-stock companies in Russia and other developing markets of former Soviet countries suggests that the development of the corporate sector and the stock market requires corporate governance level of the companies that corresponds to international standards. The reason for it is that investors pay a lot of attention to the degree of compliance with the basic principles of good corporate governance. The Russian Code of Corporate Conduct was adopted in 2002 and has not been revised until now. Many factors that pointed out the need for a new regulating document forced FFMS of Russia to announce about a project development for a new corporate governance document, whose original term of adoption was set to summer 2013, but had to be postponed since then. The goal of the paper is to provide a scrutinized analysis of the old Code of Corporate Conduct and its new edition in order to follow the progress of corporate governance in Russia over the last decade. Also some implications on what it means for the future of corporate governance in Russia and comments on how the Code could be improved are given. Also, a comparison of the state of corporate governance in Russia with other BRIC countries is given. The research has shown that the new document has a lot of improvements against the Code of 2002. However, poor enforcement of legislation makes the issues of compliance, monitoring and enforcement of the new Code's provisions of major importance in the next years. Comparison with one of the BRIC countries – Brazil – showed that Brazilian Code is more up to date and that in Russia investors feel themselves less comfortable in terms of compliance with legal regulations. However, the number of reasons show obvious progress supported by the evidence of changes on the company and regulatory level, which has a potential for eliminating the problems inherited from the Russian economy with strong involvement of the state.

## Abstract

Die Tätigkeiten von Aktiengesellschaften in Russland sowie andere erschließende Märkte von früheren Sowjetischen Staaten, zeigen dass die Entwicklung für zusammenarbeitende Bereiche im Aktienmarktbereich ein Niveau der Regierung für Übereinstimmung eines internationalen Standards benötige. Der Grund dafür ist, dass die Investoren sehr viel Aufmerksamkeit auf den Grad der Ordnungsmäßigkeiten legen, im Grundprinzip ist die gut zusammenarbeitende Steuerung ein wichtiger und einer der ansteigenden Faktoren im Investmentgeschäft und dessen Entscheidungen. Der Russian Code von zusammenarbeitenden Leitungen wurde 2002 implementiert und seitdem nicht geändert. Doch viele Faktoren zeigen eine Nachfrage für eine neu geregelte Urkunde auf. Das brachte FFMS von Russland darauf ein Projekt zu entwickeln und zu verkünden, dass die neue zusammenarbeitende Steuerungsurkunde im Sommer 2013 angeglichen würde, doch diese wurde seitdem zeitlich verschoben. Das Ziel dieses Dokumentes ist eine genaue analytische Prüfung der Kennzahl der zusammenarbeitenden Leitungen des alten Dokuments und die der neuen Auflage, um den Fortschritt des letzten Jahrzehnts der corporate governance in Russland nachzuvollziehen. Weiters sind die Auswirkungen für die Zukunft von zusammenarbeitenden Leitungen in Russland zu betrachten, um Äußerungen für Verbesserungen der Kennzahlen geben zu können. Auch eine Gegenüberstellung der Staaten mit zusammenarbeitenden Leitungen in Russland mit anderen BRIC Ländern kann gegeben werden. Die Forschung zeigte auf, dass das neue Dokument viele Verbesserungen gegenüber der Kennzahlen von 2002 hat. Wie auch immer, die geringe Durchsetzung der Gesetzgebung macht die Einhaltung, Beobachtung und Durchführung der neuen Kennzahlenbestimmung zur hauptsächlichen Wichtigkeit für die nächsten Jahre. Die Komparation mit einem BRIC Land, Brasilien zeigt den Beweis, denn dessen Kennzahlen wurden auf neuesten Stand gebracht. Doch die Investoren in Russland fühlen sich immer noch durch die Bestimmungen der gesetzlichen Regelungen unkomfortabel. Es gibt etliche Gründe die die Unterstützung für einen Fortschritt offensichtlich zeigen, mit einer Beweisführung von Entwicklungen im Unternehmen und der ordnenden Ebene, die das Potential für Behebungen der Probleme nach sich zieht, welche von der Wirtschaft in Russland übernommen wurde mit einer starken Beteiligung des Staates.

## Curriculum Vitae

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| 03/2011 – 03/2014 | University of Vienna, International Business Administration  |
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