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Corporate Governance in Russia: Past, Present, and Future

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The emergence of corporate governance in Russia is a recent phenomenon. Following the collapse of the Soviet Union, politically motivated privatization produced a system where corporate governance was not valued and shareholders were unable to come together to restructure and develop their companies. At the end of the 1990s, businesses were still poorly governed and investors and minority shareholders had few rights under the law.

Since then, corporate governance practices regarding shareholders' rights, board and management operations, and transparency and disclosure have been adopted. However, much work remains, as companies still face obstacles to business success and good governance. Although the legacy of communism is slowly weakening and the business environment is becoming more predictable, corporate governance practices must be implemented in all companies before the investment environment in Russia can be considered trustworthy. That being said, good governance does not become institutionalized overnight, and the progress made by many Russian companies demonstrates that businesses are determined to join the global economy.

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Introduction

The emergence of corporate governance in Russia is a recent phenomenon. During the Soviet period, corporate governance was practically nonexistent, as the behavior of companies was distorted as a result of the command economy. Following the collapse of the Soviet Union, wildcat privatization produced a system where corporate governance was not valued and shareholders were unable to come together to restructure and develop their companies.

Toward the end of the 1990s, capitalism was flourishing but businesses were poorly governed and investors and minority shareholders had few rights under the law. Since then, corporate governance practices regarding shareholders' rights, board and management operations, and transparency and disclosure have been adopted. However, much work remains, as companies still face obstacles to business success and good governance.

The Russian Institute of Directors (RID) is one organization working to improve corporate governance practices in Russia. It assists Russian companies in adopting good corporate governance practices, as well as provides information on the development of corporate governance practices domestically and abroad. It also conducts corporate governance audits and holds regular training courses for board members and company secretaries. In addition, RID works with government agencies responsible for regulating corporate governance and security markets, and it has developed a National Registry of Corporation Directors.

The Emergence of the Corporate Environment in Russia

Most Russian companies, including joint stock companies, emerged as the result of privatization. Unfortunately, the privatization process was not entirely fair and transparent, although it was designed to give every Russian citizen the opportunity to buy stock. Since the majority of Russians lacked the capital to purchase stock, the reformers in charge of the privatization process decided to give away shares rather than sell them. It was politically untenable to hold for-

profit auctions because the only people with the funds to buy stock were foreigners and a handful of successful Russian entrepreneurs.

The assets of many state-owned companies were converted into stocks and approximately 20-25 percent of those shares were distributed to the personnel of the enterprise being privatized. In addition, the government distributed vouchers worth approximately \$30 to all citizens, who were then invited to attend public auctions to purchase companies' stock.

As a result, the controlling shareholders of the newly privatized companies did not learn of their status until after the shares were distributed. They were in a very unfortunate position, as they were expected to turn formerly state-owned enterprises into modern, profit-making private companies without any financial contribution from the other shareholders. The companies' owners considered the shareholders to be pseudo-shareholders because although they held stock, they had not contributed any funds to finance the development of the companies. The shareholders received their stocks solely because they had worked for the enterprise in question during the Soviet period or obtained stock using the free vouchers distributed by the government.

When these individual shareholders sold their stocks to investment companies and the investment companies demanded dividends, the companies were unable to produce any. The controlling shareholders were trying to restructure their enterprises from the ground-up – with no financial support. Therefore, they perceived the demands for dividends as groundless because the demanders in many cases had not contributed anything, financial or otherwise, to the company.

It is important to understand that the newly privatized companies were not in good shape. State-owned enterprises that operated during the Soviet period were not expected to earn a profit, operate efficiently, or produce useful products. They employed an excess number of workers; produced an abundance of goods that consumers did not need; and did not produce enough of the products people needed on a daily basis, such as toilet paper, soap, or diapers. The service sector was practically non-existent.

In addition, the quality of the infrastructure and equipment inherited by the new owners was abysmal. Machinery was old and inefficient, and it was nearly impossible to obtain supplies and raw materials. For example, the equipment used to extract oil from the deposits in the Ural Mountains was old and broke frequently. Unfortunately, the only factories that produced replacement parts were located in Baku – now the capital of independent Azerbaijan. To remedy all of these problems without funding was simply impossible.

Thus, there was a conflict between those who were given free shares for their past affiliation with those enterprises – and believed they were entitled to such a *gift* – and those who paid for their shares. The controlling shareholders felt pressure from two sides, and it was unfair. They had spent money to buy stock, to develop the companies, which needed significant capital investment, and they were expected to pay large dividends. Simply put, it was a conflict between those interested in the long-term success of the company and those who cared about short-term profits.

Eventually, that attitude toward shareholders had to change. By the end of the 1990s, the controlling shareholders had consolidated their control over their companies. At that point, they had to begin to attract investors, and they came to understand that investors would be unwilling to invest in a company that ignores minority shareholders.

That is why a group of companies – companies whose strategy was to grow and to attract investment – changed their approach to shareholder relations. However, that was impeded by the structure of many privatized companies. A number of these enterprises were artificially transformed into joint-stock companies, but by the nature of their business, they were actually private companies. So, there were bakeries and dairies that were considered major stock companies, but their business could not be conducted as a public company.

Thus, these companies devolved into private companies and conflict between the minority shareholders and the controlling shareholders remained. Gradually, this is being settled, as the majority shareholders are buying out the minority shareholders

or the assets are being transferred to newly registered companies – a practice that is often legally questionably or outright illegal. Unfortunately, this was necessary because many formerly state-owned enterprises simply could not transition to public status.

Starting in the mid-1990s, people began to open new companies. Most of these companies were private companies. However, some of them were created as public companies, with the aim to attract investment. Another group went public soon after establishment. This group of companies has been very successful. In fact, Russian companies like MTS and VimpelCom are now listed on the New York Stock Exchange.

Corporate Governance Trends

The number of public companies in Russia has been growing rapidly. These companies attract investment through private placement and work with private equity funds, which is a special category in terms of corporate governance. In addition, there are roughly 340-400 companies that have been moving toward becoming public companies.

To understand the state of corporate governance in Russia, it is essential to address shareholders' rights protection, board and management operations, and transparency and disclosure.

To measure these indicators, since 2002, the Russian Institute of Directors (RID) has been conducting regular surveys on corporate governance practices in Russia. The other source of information was the National Corporate Governance Rating project that RID has been carrying out since 2003.

Protection of Shareholders' Rights

There have been positive developments in the area of shareholders' rights protection. In particular, there has been a significant improvement in terms of preparation for and conducting shareholders' meetings. Under Russian law, such meetings must be held annually, and that practice is observed by all companies mentioned in this article. In addition, shareholders must be given 30 days' notice before the date of the annual shareholders' meeting.

The process for developing the meeting's agenda has also improved. Under Russian law, every shareholder who owns two percent or more of the company's stock has the right to submit proposals to be included in the meeting's agenda. The board of directors must seriously consider each of the proposals. Shareholders then receive a packet of materials in the mail to prepare for the annual meeting. That package of materials includes the annual report, the agenda, a list of candidates nominated for election to the board, and other materials.

In addition, the practice of asset stripping has declined. In many companies, it has become quite a rare phenomenon because the controlling shareholders of these companies believe that it is in their interest to raise the value of their companies.

The practice of hiring independent auditors has become commonplace. All Russian companies that strive to attract investment now retain the services of the Big Four auditing firms [PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young, and KPMG]. All companies that are listed on one of the two Russian stock exchanges, the London Stock Exchange, or the New York Stock Exchange use one of these firms, as well.

There have also been improvements in dividend policies. First, a growing number of companies have adopted dividend policies that outline the principles governing when the company will pay dividends.

The tax authorities have involved themselves in this process. Although their interest often exceeds reasonable limits, it has had a positive influence in some areas. That pressure made the growing number of controlling shareholders believe that there are fewer risks if they gain benefits through paying dividends. Although it is necessary to pay a profit tax and then to pay a nine percent tax on dividends, there are fewer risks to earning a profit through dividend payments. Both minority and majority shareholders benefit from this.

There have also been improvements in the development of depositories, the laws governing them,

and the registration of title rights. In fact, there have not been any major scandals in this area since 2001.

However, Russia still faces a number of challenges in the area of investors' protection rights. Problems arise because under Russian law, a shareholder or a group of shareholders that hold 10 percent or more of the stock have the right to ask the board of directors to convene an extraordinary meeting. During the extraordinary meeting, the group has the right to elect a new board, appoint a new CEO, and prompt other major changes.

Due to a high concentration of ownership, it is not difficult for a group of minority shareholders to achieve the 10 percent threshold. Once this group holds the extraordinary meeting, the company faces a situation of parallel leadership: two boards of directors, two management committees, executive committees, and so on.

Board and Management Practices

There are many issues concerning board and management practices that must be addressed in the Russian context. First, foreign consultants often advise that there must be a law defining the relationship between the CEO and chairman of the board. In general, the CEO is well-supervised by the chairman, which prevents abuses of funding and remunerations.

A problem arises when the CEO is a controlling shareholder himself. Thus, there is not a division between the positions of chairman and CEO because the chairman is in control of the majority of the shares that the CEO owns. It is also problematic if the CEO is a hired executive and is beholden to the controlling shareholder. In that situation, the controlling shareholder might tell the CEO to implement decisions that benefit the majority, but not minority, shareholders. However, because Russian companies are tightly held, the need to mandate split CEO and chairman positions is not necessary.

Russian law mandates an annual reelection of all board members. If the board is not reelected, any decisions it makes are considered invalid. For this reason, the law is usually observed. The only problem

with this is that elections are not anonymous, so every board member knows who supported him.

The opportunity for minority shareholders to elect candidates to the board has improved since accumulated voting was implemented in July 2004. Under the law, every shareholder or group of consolidated shareholders that owns two percent or more of the stock can nominate candidates. Those nominees must be included on the ballot.

There is also a law that imposes limits to the amount of time executives can sit on the board of directors. Under the law, no more than 25 percent of board members can be simultaneously serving as executive directors. The law is a bit vague in that it says that the 25 percent should not be executives who are members of the executive committee.

Corporate secretaryship has been developing. All companies listed on Russian exchanges have company secretaries, and that institution has been steadily developing. However, it is still poorly understood, and many company secretaries are expatriates.

There has also been a steady increase of the number of board committees. Although it depends on listing rules, each company should have at least two board committees: an audit committee and a nomination committee. In that vein, in order to ensure that major decisions are made collectively, many companies now have executive committees. However, it is important to note that the new listing requirements took effect on January 1, 2006, and companies have at least a year to meet these requirements. Thus, not all listed companies have formed the two requisite board committees yet.

The major problem Russia faces in regards to board and management practices is the issue of outside directors. These outside directors clearly understand which stock owners vote for them to be on the board, and that threatens the very independence of the board. In fact, board members clearly understand that this is an instrument of control.

A limited number of companies have independent directors, and in most instances, there are only two

or three. Only three or four companies' boards are composed of 50 percent outside directors, and in none of the companies do outside directors constitute a majority.

In Russia, companies also face the problem of what are called "betting generals" acting as outside directors. These are Russians or expatriates who sit on boards but have no responsibilities. For example, Yukos' board was composed of a majority of outside directors, but none of them defended the company when it was accused of tax fraud.

There is also some confusion with regard to executive remuneration because the criteria used to determine executive remuneration are not always clear. There is no independent outside monitoring, as in the United States, of executive remuneration. In fact, a formal evaluation of executives' performance is not mandatory – and often does not occur. Finally, a law governing sanctions against board members does not exist in Russia. There has not been a single instance of a successful lawsuit against a board member, which is a serious problem.

Transparency and Disclosure

Transparency and disclosure is the third issue that must be addressed in order to discuss the state of corporate governance in Russia.

There have been many positive advances in this sphere. There are two regular nationwide contests to determine which companies produce the best annual reports. There are two because they are led by competing stock exchanges, and RID representatives are judges on both panels. Since these contests began seven and six years ago, respectively, there has been a notable improvement in the quality of Russian companies' annual reports.

In addition, all companies that have issued securities must maintain a website. Although it is mandated by law, many companies have embraced the internet and have worked to build and improve their websites. Contests are regularly held to determine the best corporate website.

The law also requires that companies disclose their major events within two days, either on their website or through news agencies. Due to these measures, disclosure has been improving. Russia is experiencing better disclosure performance results, primarily related to production of goods and services, and better financial accounts disclosure. However, much work remains. The improvement of disclosure is very uneven, as a small group of leading reformers have advanced far beyond the majority of Russian companies.

That difference is quite large. For example, under Russian law, there is no requirement for beneficiary ownership disclosure, although a company cannot issue securities, stocks, or bonds without disclosing the identity of the beneficiary owners. The caveat is that they can disclose just the legal entities and not the beneficiary owners. A small number of companies are disclosing this information by choice because they understand that investors will not buy their securities without that knowledge. Those companies are the leaders in reform.

In addition, financial accounts frequently lack necessary information. Most companies compile their financial reports based on the minimum amount of information required by law, such as profits and losses. In fact, there is no disclosure whatsoever on the correlation between a company's performance and its executive's remuneration. This is because according to the law, the company may disclose just a total amount that it pays to executives and to board members, without itemizing the expenditures.

Obstacles to Improving Corporate Governance in Russia

Although there have been many improvements in corporate governance in Russia, companies that attempt to implement good governance practices frequently run into institutional barriers. The business legislation on the books is of poor quality and the court system is antiquated and inefficient. Thus, while companies now have the internal resources to improve governance, the legal environment in Russia is a limiting factor.

Since Russia has no precedent law, judges may issue opposite rulings on similar cases – and that is a very serious problem. A related problem is a legacy of communism. Most judges were educated during the Soviet period and learned socialist economics. They have a poor understanding of business practices and market economics. For this reason, their verdicts often seem arbitrary and illogical. And, due to their small state salaries, judges are susceptible to bribery and other types of corruption.

Finally, the penalties for breaking the law in business transactions are very mild. In fact, the punishment for minor crimes like petty theft is much stronger than for offences like deceiving investors, cheating business partners, or embezzlement.

The Road Ahead

Many corporate governance issues that Russia faces are not unique to Russia. In fact, they are not even unique to the developing world. Although Russian companies must do a great deal to improve their corporate governance practices, certain paradigms need to be broken.

First, the perception of the relative risks of corporate governance in advanced and emerging markets should become more realistic. We all must understand that the issue is not black and white – good corporate governance practices cannot be adopted overnight, and poor corporate governance practices will not instantly ruin an entire economy. Corporate governance is developing in Russia, and as long as companies are making progress, the risk inherent in investment is mitigated to a certain degree.

In 1998, Russia experienced an economic crisis when the Russian government defaulted on its loans and devalued the ruble – and many analysts blamed poor corporate governance practices. While it is true that investors lost a great deal of money, most of the lost funds had been invested in high-yield government-issued bonds, not private companies. So, although Russia's credit rating suffered and investors fled, the default was not due to corporate governance failure,

but rather the result of irresponsible macroeconomic policy.

Instituting corporate governance best practices takes time, and it is not prudent to divide the world into countries with good corporate governance and those without. Investors should have reasonable expectations and take a more balanced approach when analyzing an investment environment.

Second, it is not enough to adapt corporate governance best practices to be used in the Russian environment; those best practices must be institutionalized, as well. Since board members are often elected by a large number of individual investors, the board members do not feel any particular affiliation to any investors. However, if that board member is elected by the shareholders, people he knows, a conflict of interests arises. At that point, the board member is clearly dependent on the shareholders who voted for him.

Of course, that board member might forsake his benefactors and act on his own volition. However, due to the vagaries of Russian law, that is very unlikely. A group of shareholders controlling at least 10 percent of the stock could easily call an extraordinary meeting to remove that wayward board member. So, it is difficult to determine what “fiduciary activity” should mean for companies that are tightly held. Should it mean that investors should not have the right to reelect board members for a set period? This issue has not yet been decided.

A problem arises when a set of corporate governance regulations are recommended and imposed from above. These declarations may be very useful, but without implementation, they do not improve anything.

In addition, an avalanche of best practices recommendations that cause a bureaucratization of the business process will not improve the business environment. In Russia, as in many developing countries, businesses are often entrepreneurial ventures. Too many regulations will suffocate that small business and impede growth. Certain best practices work well

for large companies in advanced markets, but actually stifle economic growth in developing countries.

In addition, there should be a more realistic approach to determining the amount of information that a company must disclose. Currently, there is a serious problem with global financial information institutions that affect corporate governance.

The largest problem concerns the independent audit that is required of all companies. The origin of the problem lies in the structure of the auditing industry; there is an oligarchy of four major firms. Even though there is not a wide choice, the company’s audit committee must do a great deal of work to select an auditor according to a set of lengthy guidelines.

When it comes time to conduct the audit, a junior auditor comes to check the financial accounts and a partner comes to oversee the final stage and approve the report produced. The problem lies in the ability of the auditors to detect fraud. An interview with William McDonough¹ in the December 1, 2005 issue of the *Financial Times* put it well, in that “even the best auditor is ‘highly unlikely’ to spot collusive fraud that involves a small number of people.”² Thus, if the auditors are sometimes unable to identify instances of fraud, the independent audit could be considered a tax imposed on companies.

The biggest problem is that investors want companies to adopt corporate governance best practices without paying the price. Investors espouse good corporate governance, but they rarely take corporate governance standards into account when deciding where to invest. Instead, they insist that companies meet the bare minimum standards before they invest, but after that, they refuse to pay premiums to help companies improve their corporate governance standards.

For example, Sibneft, the Russian oil company, was the darling of investors. The reason was because there was a high rate of return. Because its owner held 92 percent of the company, he was willing to pay huge dividends because the majority of the profit was retained by him. Investors, however, did not consider

this – they considered the profits. And this is just one of the many examples in Russia.

Conclusion

Corporate governance in Russia has developed steadily since the collapse of the Soviet Union. Companies have learned that in order to attract investment, business practices must be fair and transparent. However, there are a number of obstacles to overcome. Although the legacy of communism is slowly weakening and the business environment is becoming more predictable, corporate governance practices must be implemented in all companies before the investment environment in Russia will be trustworthy. That being said, good governance does not become institutionalized overnight, and the progress made by many Russian companies demonstrates that businesses are determined to join the global economy.

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¹William McDonough is the former Chairman of the Public Company Accounting Oversight Board.

²Andrew Parker, "The Man Who Put Auditing First," *Financial Times*, London Edition, December 1, 2005 (accessed through LexisNexis).

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For more information about the presentation on which this article is based, please visit <http://www.cipe.org/programs/roundtables/weevents/041306.php>.

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