Improving Corporate Governance in Russia and the EU

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The advance of modern codes and principles of corporate governance – which involve the system of relations between the shareholders, board of directors, investors and management of a company as defined by the corporate charter, bylaws, formal policy and rule of law – has acquired a global character. Experts at the Organization for Economic Cooperation and Development (OECD), which oversees the promotion of international standards in corporate governance, notes that progress has been made by a number of countries in East and Southeast Europe (Hungary, Russia, Croatia and the Czech Republic) and Latin America (Argentina, Brazil, Colombia and Chile). In this sphere, the interests of the state and business intersect: both equally need a favorable and transparent business environment. A well-built corporate governance system is an essential condition for the growth of capitalization, development of the stock market, and creation of an investor-friendly economic environment.

Corporate governance practices in the EU and in Russia differ considerably. There are, however, certain objective and subjective factors that allow for comparisons and analogies to be made. Furthermore, even within the Euro zone, corporate governance institutions differ in the levels of their maturity. These differences became especially pronounced in the wake of EU enlargement with a number of East European states, although several “old” EU members (e.g., Portugal or Greece) are only slightly ahead of Russia in the development of such institutions.

In Europe, it is the state that calls the shots in reforming corporate governance. The business community – not only in Russia, but also in many European countries – is not yet self-organized and self-sufficient enough to influence the formation of corporate governance principles. The prevalence of concentrated ownership in Russian and the majority of European companies has a substantial impact on such essential aspects of their activity as relations between shareholders and management of a company, transparency, and the status of independent directors.

Comparative analysis of certain corporate governance institutions in Russia and major EU countries also shows that they have much in common. For example, boards of directors in France, Germany or Italy, as in Russia, are not particularly active and are mainly comprised of ‘insiders’ – companies affiliated with the owners and management. Minority shareholders are clearly in the minority there. In the U.K. and the United States, boards of directors are vigorously active and include mainly independent directors.

MODERNIZATION OF CORPORATE STANDARDS: THE EUROPEAN APPROACH

In recent years, the European Commission (EC) has visibly intensified its efforts of improving corporate legislation and corporate governance practices. EU commissioner for internal market and services, Charlie McCreevy (former Irish finance minister), incumbent since November 2004, consistently supports the initiatives put forward by his predecessor, Frits Bolkstein (former Dutch defense minister).

In the Old World, this problem was given high priority in the wake of a series of corporate scandals (involving Parmalat, Vivendi Universal, Royal Ahold, Skandia Insurance, Adecco, etc.) that made institutional investors and shareholders aware, like never before, that they had to deal with a serious risk factor. The EC's efforts to institute an effective corporate governance system are dictated, in equal measure, by the desire to restore trust in the stock market and, most importantly, to stop the decline in EU economic growth rates. Furthermore, European companies whose shares are listed on U.S. stock exchanges must comply with the accounting requirements of the Sarbanes-Oxley Act (2002). Finally, the admission of new members to the EU (Hungary, Poland and Czech, and others) highlighted the need for harmonizing corporate governance models and bringing them in line with EU standards.

Today, work is underway in EU member countries to adapt the existing corporate governance codes to the OECD Corporate Governance Principles adopted in 2004. EU officials are increasingly talking about the convergence of legislative and regulatory documents to improve corporate governance practices within the entire European Union. EU officials say that this will not lead to the elimination of country (national) models that evolved under the influence of national political and cultural traditions. Furthermore, they deny the possibility of enacting a European Code of Corporate Governance, along the lines of the European Constitution.

According to McCreevy, the role of the EC is to coordinate the efforts of EU members with an aim at improving corporate governance practices by amending national laws and codes of corporate governance. It is important to remember that EU countries have different historical traditions that should be treated with respect. At the same time, it is essential to eliminate divergences in the legislative sphere that hinder the creation of a single financial market and create additional impediments to investors.

The European Corporate Governance Forum, a body designed to set priorities and work out recommendations, was launched in October 2004. It is made up of 15 experts representing a range of stakeholders, issuers, investors, regulators, auditors, and academic circles. Its members include Antonio Borges, the vice chairman of Goldman Sachs International; Alastair Ross-Gooby, who until recently was chairman of the International Corporate Governance Network; Jaap Winter, professor of Amsterdam University; De Brauw Blackstone Westbroek PC; and others.

The Forum was created as part of the Action Plan on Corporate Law and Corporate Governance, adopted in May 2003. Under the Action Plan, the EC has for the past two years been publishing regulatory documents designed to help national governments lay the groundwork for EU principles in this sphere. Compared with the tough requirements of the Sarbanes-Oxley Act, the proposals by EU regulators appear milder and are mainly of an advisory nature and non-binding.

The Forum's sessions last year in Brussels and Luxembourg (January and June 2005, respectively) showed that the main problem area in EU corporate governance practices, according to the EU's "committee of wise men," is within the realm of shareholder empowerment. In particular, foreign shareholders are confronted with serious legal impediments in exercising their rights. Meanwhile, according to the EC, public companies in large EU states have 30 percent to 35 percent of foreign shareholders, while companies in small European countries have between 70 percent and 80 percent. There is also a pressing need to improve corporate control mechanisms to minimize investment risks.

The EC code of recommendations prioritizes the interests of shareholders. This refers to expanding shareholders' access to information about management and board of directors' activity, their participation in discussions and attendance at voting at general meetings, and giving them a greater role in decision-making on management compensation policy. Top management salaries should be transparent and linked to a company's financial performance. In a special recommendation (December 2004), the EC directed the Spanish government to amend its national legislation to end discrimination against minority shareholders, in particular by issuing additional shares. In the interests of shareholders, the EC Directorate General for Internal Market and Services urged issuing companies to publish special annual reports disclosing in detail corporate governance practices and procedures.

At the same time, European regulators are aware that should shareholders' influence in corporate management move beyond a certain level, this could effectively nullify the role of management, turning it into a purely bureaucratic appendage. The latter, incidentally, is fraught with greater risks, as well as a possible decline in economic effectiveness. Ideally, the regulators believe that the interests of shareholders and management should coincide.

Other EC recommendations include increased representation. This move would include a greater role of independent members of the board of directors, on order to harmonize the relations between management and majority and minority shareholders; a greater priority would be given to their professional qualifications. The advocates of uniform standards also propose improving the level of responsibility toward the investors and shareholders in relation to the decisions made by members of the Board of Directors – above all in financial matters.

At the same time, certain EC recommendations are failing to secure the understanding and approval of national governments in those European countries where national corporate governance traditions took decades to evolve. Countries of the Old World, where, in contrast to the United States, concentrated rather than "dispersed" ownership structures prevail, do not see much point in a forced expansion in the number of independent board members. For example, Sweden's latest version of the code of corporate governance basically preserves the practice of granting majority seats of the boards of directors to representatives of majority shareholders.

The EC principle of guaranteeing the equality of shareholders is coming up against traditions, especially in medium-sized French companies where the “veteran” shareholders enjoy a privileged position compared with “young” shareholders (e.g., in voting at general meetings). The EC’s stringent disclosure recommendations have also stirred heated debate within the business community. For instance, top management at major German concerns is obviously less than enthusiastic about the idea of introducing mandatory disclosure claims of board member compensation arrangements. Not surprisingly, shareholders, supported by the German Federal Government, insist that this procedure be made into law.

The vector of change outlined by the EC does not mean a move toward the U.S. model, however, with its over-regulation and excessively tough and detailed requirements. Brussels officials prefer a more uniform corporate governance model that would take into account national specifics and be based on a flexible combination of mandatory and non-binding procedures.

CORPORATE LEGISLATION IN RUSSIA

In Russia, as well as in other transitional economies, the state and business community have yet to create an institutional and legal framework for a full-fledged corporate governance system. In the opinion of Russia’s more far-sighted business leaders, this sphere of activity is increasingly taking on a financial and economic dimension. Russian business majors are spending more money on improving corporate governance practices. Corporate transparency strengthens a company’s reputation, while ultimately yielding more dividends than through the dubious practice of skimming profits into offshore accounts. To foreign investors, this development is just as important as witnessing progress in macroeconomic indicators. Not surprisingly, this aspect is often highlighted by many Russian companies at their road shows (meetings, presentations and conferences with members of the investment community) held in the West.

It is no secret that the level of corporate governance in Russia is still far from European standards. At the same time, a number of Russian companies have been demonstrating good results in this sphere. In general, however, progress remains rather limited. In the past one or two years, the biggest achievements have been made in creating new corporate governance instruments and procedures. The decision-making role of various corporate boards of directors is increasing as the number of major deals subject to their approval is expanding. Companies are streamlining their structure, in particular by setting up specialized committees – on auditing, human resources and remuneration, strategic planning, relations with investors, etc. Furthermore, the proportion of independent members on boards of directors continues to increase not only at large but also medium sized companies. At some large companies and banks, beneficial owners (real owners of securities not subject to promulgation) are moving from operating control to strategic planning, leaving company management to run day-to-day activities (the

Magnitogorsk Metallurgical Plant, the Pipe Metallurgical Company, SUAL Holding, MDM Bank).

Another factor involves foreign capital in Russia. The presence of European and U.S. capital in Russian companies (Vympelkom, TNK-BP, Wimm-Bill-Dann, Lukoil) has a positive impact on the state of their corporate governance.

Russia's shortfalls in the realm of corporate governance are typical of transitional economies. At worst, corporate governance is oftentimes seen as a mandatory ritual that companies must adhere to; at best, it represents a free pass to the stock market. Needless to say, the legal framework remains insufficient and lags behind the needs of domestic business.

Corporate legislation in Russia is marked by substantial internal contradictions and outdated norms and regulations. This results in numerous corporate conflicts related to the re-division of property, while the danger of hostile takeovers and mergers increases investment risks and the concentration of ownership. As a result, the volume of publicly traded shares on the Russian stock market remains insignificant.

In light of the abovementioned situation, there is a pressing need to amend and adjust legislation regulating corporate conflicts, mergers and acquisitions, and relations between majority and minority shareholders. Other areas of concern involve dividend policy, the use of insider information, conflicts of interest, and affiliation criteria.

In late 2004 to early 2005, an attempt to achieve a breakthrough in adjusting company law was made. Within the space of a few months, three state regulatory bodies offered their vision on how to develop Russian corporate law. First, the State Duma Committee Property Committee issued recommendations in November 2004. Then in May 2005, Expert Council on Corporate Governance of the Economic Development and Trade Ministry (EDTM) put forward for discussion a draft concept of corporate law for a period until 2008. The Council comprises a number of reputable experts on company and finance law representing the Research Center for Private Law (the Office of the President of the Russian Federation), the Russian Lawyers' Union, and Baker & McKenzie. The Council is chaired by Deputy Minister Andrei Sharonov. Finally, in June 2005, the Federal Service for Financial Markets came out with a strategy for the development of Russia's financial market that also contains a number of proposals on improving corporate legislation.

It is expected that the key provisions of these documents will be approved at a Cabinet session and integrated in the form of amendments and additions to the feeral laws *On Joint-Stock Companies*, *On the Securities Market*, and others.

The EDTM concept contains a number of practical recommendations on improving corporate governance. This refers in particular to further downsizing the number of executive directors on boards of directors with a view to distancing them from managerial structures. One serious shortfall in Russian corporate governance practice is the weakness of the internal control system and its subordination to company management. There are also proposals concerning the formation of audit commissions, which would involve various strategies, such as banning all company executives from being elected to audit commissions, and introducing cumulative voting in the election of members so as to take into account the opinion of minority shareholders and ensure their representation.

Current legislation lacks provisions about the liability of independent directors who have harmed their company by voting contrary to its interests but in accordance with the wishes of “their” shareholders. To this end, there are plans to amend the federal law *On Joint-Stock Companies*, specifying the duties of board members and laying down action procedures by the Board of Directors in the event of a conflict of interests between a company and its shareholders.

Russian corporate legislation has yet to address issues related to insider information. Meanwhile, share prices are being constantly manipulated on the stock market. For example, in April 2003, insiders cashed in on rumors about the YUKOS-Sibneft merger that never materialized. According to the federal law *On the Securities Market*, the circle of individuals privy to inside information is rather narrowly circumscribed and does not include, e.g., members of the board of directors, the audit commission, or major shareholders. Today, a bill *On Insider Information and Market Manipulation* is pending in the State Duma. It provides a clear definition of “insider information,” while giving a list of securities that can be affected by insider trading. The bill would ban the use of such insider information, and expand the scope of insiders to include not only corporate executives, but also state and government officials who have access to an issuing company’s database.

There is also a pressing need to amend the Corporate Code of Conduct that was prepared in keeping with OECD standards. This document was approved by the Russian Government in February 2002, and remains the main guideline for companies seeking to follow modern principles of corporate governance. A *Financial Market Development Strategy*, formulated by the Federal Service on Financial Markets, proposes amendments to the Corporate Code of Conduct, such as the creation of independent boards of directors, preparation and disclosure of consolidated financial statements to international accounting standards, and the impermissibility of insider trading.

There have been few changes in the status of minority shareholders. Today, Russian business majors have almost 188,000 minority shareholders who own a total of $3.1 billion worth of stock. Their status remains one of the most serious problems in the field of corporate governance even though many companies are striving to earn credentials as being “minority friendly.” Shortfalls in Russian corporate governance practices include the infringement of minority shareholders’ rights, the insufficient role they have in the decision-making process, and the shortage or complete absence of their representatives on boards of directors.

The EDTM and Duma documents give priority to creating legal mechanisms of protection against hostile takeovers. In particular, proposed amendments to the federal law *On Joint-Stock Companies* prohibit the seizure of the shareholders’ shares involving enforcement proceedings, as well as guaranteeing that decisions by a general shareholders’ meeting held without approval from the board of directors will be deemed null and void. The interests of a majority owner can also be secured by squeezing out minority shareholders from a company through a forced buyout. In practice, a considerable part of corporate takeovers is accomplished through an extraordinary general shareholders meeting conducted by minority shareholders who control a total of less than 10 percent of stock. In this context, the EDTM Expert Council on Corporate Governance has recommended an amendment whereby an extraordinary shareholders' meeting may only be convened by a group of minority shareholders once a court has ruled that the refusal by the board of directors to hold such a meeting was illegitimate.

The Duma Property Committee believes that minority shareholders have excessive rights that they purposely abuse. According to Committee Chairman Victor Pleskachevsky, there is a pressing need to protect companies and major shareholders against minority shareholders who act in bad faith. Under current Russian legislation, the holders of even one or two shares have the right to file lawsuits to protect their property interests, while courts may impose all sorts of restraints on companies as security for these claims, thus effectively paralyzing their operations. For instance, several years ago, a major LUKOIL deal was scuttled over a groundless lawsuit filed by a single minority shareholder.

In order to eliminate corporate blackmail, amendments have been drafted limiting minority shareholders' rights to file claims on matters concerning the convocation of extraordinary shareholders meetings, the arrest of blocks of shares, the issue of additional shares, and the reorganization of joint-stock companies. By way of compensation for these amendments, the Duma Property Committee has proposed a bill making it binding on all open joint-stock companies to distribute and pay dividends. Opponents to the idea believe, however, that such measures could result in company's underreporting their profits as a way of lessening the dividend payout.

In July 2004, the State Duma (on the initiative of the chairmen of four of its key committees: property; credit organizations and financial markets; civil, criminal, arbitral and procedural law; and constitutional law and state building) unanimously passed in the first reading an array of amendments to the federal law *On Joint-Stock Companies*. Under these amendments, the holder of a controlling stake who owns more than 90 percent of company stock has the right to buy out minority shareholders. Later in the year, however, the issue stirred heated controversy, which continues to date. In September 2004, a large group of foreign and Russian investors representing Hermitage Capital Management, Prosperity Capital Management, Firebird Management, Aton, Charlemagne Capital, East Capital, Halcyon Advisors, Morgan Stanley Investment Management, MC Trust, Third Point Management, Troika Dialog, Vostok Nafta, and Alfred Berg Asset Management, asked the Russian president to withdraw the bill. They said that the bill could hurt the interests of investors and minority shareholders in major companies. It should be remembered that in the overwhelming majority of cases, a foreign investor in Russia is a minority shareholder. Thus, the Expert Department of the Office of the President of the Russian Federation supported the investment community, thereby recommending that the bill be scrapped. As a result, the draft bill providing for a mechanism to squeeze out minority shareholders was sent back to the committee and in the summer of 2005 taken off its agenda.

Disclosure and transparency is an important factor in reducing the level and intensity of corporate conflicts. According to Standard & Poor's, domestic business is becoming increasingly transparent. The corporate transparency index of Russian business majors rose from 40 percent in 2003 to 46 percent in 2004, eventually hitting 50 percent in 2005. The Mechel Steel Group (a leading Russian mining and metals company) made spectacular progress within the space of just one year: initially beginning as an outsider, it quickly rose to become one of the top three leading mining and metals companies in Russia, along with MTS and Rostelecom. It was not the majors, however, but medium-sized companies that were a crucial factor in the index. It is noteworthy that Russian corporations are far more willing to disclose information about their social and charity activities than about the remuneration of their top executives, members of boards of directors, and external auditors. The majority of companies still shun transparency. At the same time, many top executives in Russia are inclined to see "excessive" transparency as a risk factor, contributing to hostile takeovers and administrative pressure by corrupt bureaucracy.

The main priority for Russian lawmakers at this point is to establish a clear legal framework for resolving corporate conflicts, create civilized mechanisms for mergers and reorganizations, define affiliation criteria, and regulate the use of insider information. These moves would signal a clean-up stage for creating a favorable environment, which is critical to a full-fledged corporate governance system in Russia.

Addressing the first international conference *Corporate Governance and Economic Growth in Russia* in June 2004, Ira Millstein, an expert on corporate governance, drew an interesting analogy: "Throughout its history Russia successfully repulsed invasions from foreign powers of all kinds: Germany, France, Turkey, and Sweden. At the same time, however, there is a kind of invasion that remains impossible to resist: corporate governance and the global need to attract capital to secure production growth and enhance competitiveness. This is a universal rule that was not invented in America, Britain, Germany, Canada or anywhere else. It applies to all countries. If Russia wants to become part of the global economy, it should play according to the general rules. If you want to attract capital to Russia, you'll have to live according to these rules."

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