CORPORATE GOVERNANCE OF RUSSIA'S STATE-OWNED ENTERPRISES

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In today's corporate Russia, the State remains a significant shareholder with controlling or blocking stakes in several large and dominant enterprises, which according to some studies account for roughly 50% of the country's GDP. While noteworthy improvements were made in the past years with regard to the way State-owned enterprises (SOEs) are governed, the perception, as measured by investors' valuations of Russian SOE shares, suggests that there is still much to do. Understanding the challenges of the Russian SOE sector and improving its corporate governance becomes, in this context, a key driver of potential economic growth and development. The objective of this paper is to offer a general description of the corporate governance of the Russian SOE sector. For this, we first depict the development of corporate Russia and address some key issues related to its current ownership and control structure (Section I). Second, we focus specifically on the SOE sector and provide comparative data from different sources measuring its governance and performance (Section II). Then, we address the role of the Russian State as shareholder (Section III) and we conclude highlighting areas where adoption of international best practices for SOEs could have a positive effect on the Russian economy and capital market (Section IV).

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I. DEVELOPMENT OF CORPORATE RUSSIA

Evolution of the equity market

The current Russian corporate governance landscape is in many ways the result of the privatization waves that moved the country from the Soviet system to a market economy. It is also the by-product of the efforts of the Russian authorities to curb harmful practices and foster the development of a market strong enough to supply the financing required to modernize the country. The departing point is set in the early 1990s, when a sweeping transition from State to private ownership commenced after the collapse of the Soviet Union. President Yeltsin's administration initiated an aggressive process of economic transformation, at the heart of which was the transfer of State assets to private ownership.

The nature and mechanisms of this transition process are keys to understanding the structure of Russia's private and State owned sector today. There were essentially three distinct phases in the privatization process: i) the mass privatization scheme executed between 1992 and1994; ii) the cash privatizations undertaken between 1994 and 1997, including "loans-for-shares" sales; and iii) the selective privatizations post-1997.

During the first phase, the method of privatization was determined by the size of the enterprise concerned. Small-scale privatization involved approximately 75,000 smaller enterprises largely active in trade or retail sectors being sold through either a competitive tender process or through lease purchase agreements with managers. The federal government transferred ownership of these entities to municipal control and had little involvement thereafter. For larger enterprises, they were corporatized as joint stock companies (hereafter "JSCs") before being privatized. Privatizations were conducted through the issue of 150 million vouchers with a face value of 10,000 RUB[2] each that were purchased by employees and the general public for a nominal fee of 25 RUB each. The sale process then followed three stages: first, employees and managers were offered a percentage of the privatized

[2] As of April 2014 10,000 RUB equates to USD 281, but at the beginning of 1992 it corresponded to USD 181.

firm (to be paid for in the form of both cash and vouchers); next, a second tranche was sold via a voucher auction, with participation by voucher funds that had accepted the vouchers in return for shares in their fund; and, finally, a competitive tender process was conducted for the remainder of the shares not purchased during the first two stages.

In terms of a transition from public to private ownership, this mass privatization process was relatively successful, with approximately 15,000 of the 24,000 medium and large sized firms privatized, and the rest remaining in government hands mostly as JSCs. Privatization though voucher auctions was also characterized by a number of other weaknesses including self-dealing on the part of managers. In principle, under the auction process, Russian citizens would be able to trade the vouchers for shares, but managers were able to accumulate large amounts of vouchers from a population not familiar with capitalism and with a stronger preference for cash. Auctions were allegedly also prone to irregularities, so the concentration of ownership increased.[3]

Even where outsiders were able to acquire ownership, the voucher process meant that this ownership was extremely dispersed, with little incentive for external shareholder control over management. In addition, there was negligible foreign involvement in the process and the domestic voucher funds had limited institutional capacity to manage their investments. As a result of the voucher process and the valuations placed on the companies, the proceeds to the government from the privatization were often nominal. It has been argued that at the earlier stages of privatization, the selling of the State assets was also a way to ensure a capitalist direction to economic reform, rather than just a revenue-generating exercise.[4]

The practical outcome of the mass privatization was that control of newly privatized firms passed to existing corporate managers and other insiders. The expectation that dispersed ownership would create a spontaneous demand to develop a strong legal system to protect minority shareholders was

[3] Hill, Jennifer (2004), *Comparative Corporate Governance and Russia – Coming Full Circle*, Legal Culture and Politics in the Twenty First Century.

[4] Branis, Alexander (2012), *Corporate Governance in Russia - Reality & Myth*, Prosperity Capital Management.

therefore not fulfilled. The transition occurred quite rapidly and many of the laws and institutional enforcement bodies necessary for a new legal framework were not implemented at the same pace. These draft laws or new institutions were in the process of being discussed, approved or organized, but they were not functioning in practice. Some of these reforms have only recently been completed, such as the insider trading law.

In common with other transition economies of the time, the government's fiscal position deteriorated alarmingly. Responding to this pressure the Russian government changed track in 1995. Up until then, privatization proceeds were largely re-invested in the privatized entities, but that year the federal government decided that, at a minimum, 55% of privatization proceeds were to accrue to the government. This cash privatization process was initially unsuccessful, in large part because most of the sales involved residual holdings in already partly privatized firms. Since in most cases these companies were already controlled by insiders, there was little investor appetite for the remaining minority stakes.

The difficulties encountered by the cash privatization process resulted in the "loans-for-shares" scheme, in which the government lodged its shareholdings as security with domestic banks in return for loans representing a fraction of the value of the shares.[5] While the government had the right to repay the loans and re-acquire their shareholdings, this did not happen. The net result being that substantial stakes in some of Russia's largest enterprises –such as Norilsk Nickel, Yukos, LUKoil and Surgutneftegas– were transferred to bank ownership at a fraction of their value. Auctions of these assets were often administered by the banks, which could participate in them as both bidders and depositories for bids. The participation of foreigners was restricted and competing bids were said to be often disqualified on technical grounds.[6]

[5] It should be noted that in the years preceding the "loans-for-shares" programme a large number of new bank licenses had been issued, so most company groups had their own banks.

[6] Hare, Paul and Alexander Muravyev (2002), *Privatisation in Russia, Research Paper Series*, Russian-European Centre for Economic Policy.

Post-1997, as the transition from the socialist development model became more gradual, privatization transactions ceased to be conducted on a large scale and methods became too diverse to make meaningful generalizations. One legacy of the "loans-for-shares" schemes is that they helped to further entrench a group of private owners who were already "unpopular and widely regarded by the public as illegitimate, which (made) them particularly vulnerable to official pressure".[7] This increase in ownership concentration, which took place in the context of weak legal and political institutions, involved the consolidation of power and wealth in the hands of a small number of powerful Russian entrepreneurs.

In sum, privatization did manage to introduce private property into a large portion of the economy, but failed to achieve a capital market with a broad shareholder base that would result in the development of improved corporate governance and an effective legal system. The fact that the relevant laws were initially drafted following the Anglo-Saxon model, characterized by disperse corporate ownership was faced with the quick concentration of corporate ownership in the Russian private sector, creating a combination that hampered the development of good corporate governance in Russia. Moreover, the tools the authorities had prepared to address agency problems between management and minority shareholders ended up being used for corporate conflicts among large shareholders or even for raiding by outsiders.

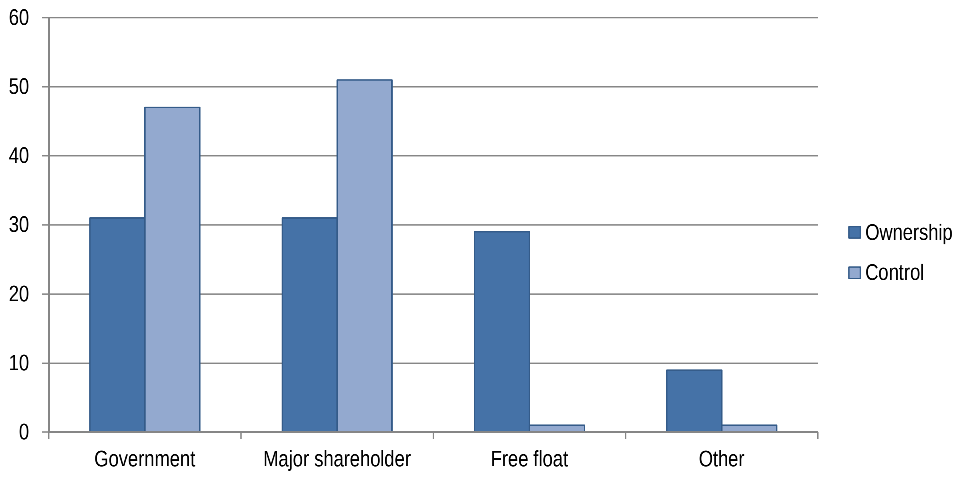
Ownership and control

The process of obtaining corporate control in the developing Russian market was often opaque, and business groups were formed or continued to evolve within very complex ownership structures involving numerous cross holdings. Combined with an ineffective framework for determining related parties and affiliates, they exacerbated the risks of abuse for minority shareholders. The history of the past twenty years of corporate governance in Russia is thereby marked by corporate disputes among controlling shareholders and block holders, between controlling and portfolio investors, as well as

[7] Tompson, William (2007), *Back to the future? Thoughts on the political economy of expanding State ownership in Russia*, Changes in Economic Power and Strategic Government Policies in Russia. Routledge, London.

attempts by the regulators to impose better corporate governance practices. This had a hindering effect on the development of the Russian capital market, reflected in part in the low free float ratios in most Russian listed companies, as well as in the discounted price-to-earnings (P/E) ratios of Russian shares in comparison to those of other BRIC countries.

Figure 1. Ownership and control in Russia (2013)



Source: Companies, Bloomberg, Sberbank Investment Research.

The current ownership structure of Russian public companies is still highly concentrated. Most of the large exchange-traded companies have a relatively small free float and the weighted share of top 10 blue chips remains high. According to our bottom-up data and Sberbank (2013) estimates,[8] in 2013 the equity market was divided in three relatively equal parts: the free-float amounts to roughly 29%, the State holds about 30% and the rest is in the hands of other controlling shareholders. Precisely due to the voucher privatizations and the loans-for-shares scheme as well as a rapid rise of the Russian market in the early 2000s, a significant gap between ownership and control emerged in Russia. As highlighted by Sberbank (2013), this gap is most significant for minority shareholders who control only about 1% of the capitalization while they own roughly 29% (Figure 1). Major shareholders and the State control 45-50% of the capitalization each, with their respective ownerships of 30% and 40%.

[8] Sberbank Investment Research (2013), *Ownership and Control in Russia. Mind the Gap*, Sberbank.

A large number of listed companies in Russia belong to horizontally or vertically integrated groups, many of them organized as diversified holding companies.[9] Company groups in Russia often involve the cross-holding of shares between companies. However, having been singled out by policymakers as a practice detrimental to the transparency of firms in group companies,[10] the level of cross-holdings in Russia has been on the decline.

As mentioned, the overwhelming majority of Russian listed companies have either a controlling shareholder or a major block holder. Among the companies that have a shareholder with a controlling interest, around a third also have a second major shareholder[11] and where several significant block holders exist, control conflicts have often ensued (Lazareva et al, 2007). Insofar as the key interest of block holders has been to maintain control or influence and defend their property against takeovers, consolidation of their stakes has been a natural ambition.

The exact extent of ownership concentration in Russia is, however, difficult to estimate. Inadequate information about beneficial ownership and limited transparency of listed companies make this quite difficult to assess. According to an S&P 2010 survey,[12] only 86% of 90 the largest companies in the survey were found to be appropriately reporting on their beneficial ownership. This shortage of information makes it difficult for the authorities and investors to identify company affiliates and control corresponding related party transactions. Nonetheless, transparency is improving gradually due to a variety of government initiatives (although many of them depend on still faulty definitions of affiliate parties and controlling shareholders).[13]

[9] Lazareva, Olga et al, (2007), *A Survey of Corporate Governance in Russia*, CEFIR Working Paper, 103.

[10] RID (2009), *Corporate Governance Practices in Russia: New Trends in 2009*, Russian Institute of Directors.

[11] National Council for Corporate Governance (2009), Avdasheva, Svetlana and Yuri Simachev, *Corporate Governance in State Corporations,* National Corporate Governance Report, NCCG.

[12] Standard&Poor's (2010), *Transparency and Disclosure by Russian Companies,* S&P.

[13] Legal reform on the definition of affiliates and controllers has been underway for over three years but heavy opposition from large companies, many of them SOEs, prevented the reform to take place in the Civil Code as proposed. Now it is to be determined where and in which form the definition will be placed, and more importantly, if it is to be effective in closing the many loopholes of the current framework.

Another important feature of Russian company groups is the presence of a banking institution at their core. In the early years of transition, entrepreneurs faced several compelling reasons for establishing or acquiring a bank. Unlike other enterprises, banks were allowed to deal with foreign exchange and could hold correspondent accounts with foreign banks.[14] In addition, in light of the weak related party framework, banks could be used as corporate treasuries for company groups. Russian banks were not subject to voucher privatization or "loans-for-shares" schemes, and many SOE banks were effectively controlled by insiders.[15] Banks continue to be used as treasuries for company groups, but many licenses have been revoked by the Bank of Russia in recent years.

II. RUSSIAN SOE SECTOR IN PERSPECTIVE

While the large role of the State in the economy is well known and easily explained as a remnant of the Soviet system, it is worth noting that the evolution has not been one-directional. Over time, the State has not only privatized, but also acquired private assets.

Consolidation of already existing State assets led to the creation of large State-owned or controlled conglomerates (e.g. Rosneft and Gazprom) which dominate their particular industry sectors and are expanding to others. This was mirrored in industries where the State was already dominant, and where the federal government consolidated a number of its existing holdings into large "national champions." Examples include United Aircraft Corporation, established in late 2006 to consolidate all State-owned businesses engaged in the manufacture, design and sale of military and non-military aircraft; Rosatom, established in late 2007 to amalgamate the full life-cycle of industries involved in the nuclear industries; United Shipbuilding Corporation, established to amalgamate 40 shipbuilding yards; and Rostechnologii, established to consolidate ownership of pre-existing conglomerates.

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[14] Barnard, Geoff (2009), *Russia's Long and Winding Road to a more Efficient and Resilient Banking Sector*, OECD Economics Department Working Papers 731, OECD Publishing.

[15] Vernikov, Andrei (2007), *Corporate Governance and Control in Russian Banks*, Center for the Study of Economic and Social Change in Europe, Economics Working Paper No. 78.

While, the "national champions" consolidated previous State-owned stakes, in some cases new conglomerates have been formed acquiring private shareholdings. The financial crisis exacerbated this tendency, giving the State an opportunity to purchase stakes in companies in a range of sectors (from financial to industrial). Yet, this trend is not uniform across all sectors. For instance, the re-organization of the electricity and rail transport sectors are two examples where reform initiatives were rooted in a market approach. According to academic studies, the expansion of State ownership has not always been based on open or consistent methods to determine company valuation. One study notes that prices for the assets acquired varied widely from close to 100% of the estimated market value for Sibneft and Power Machines and below market value for United Heavy Machinery, to almost zero for Yukos (Lazareva *et al*, 2007). The purchase of major stakes in projects from foreign investors sometimes led to questions concerning the purchase price and the possibility that non-market considerations were involved.[16]

The 2013 OECD Economic Survey of Russia underlines that the continued dominance of the largest SOEs has an important impact on the economy, as it complicates market entry and suffocates competition, while preserving pockets of inefficiency. Privatization and improved corporate governance of SOEs are therefore essential for improving overall productivity.

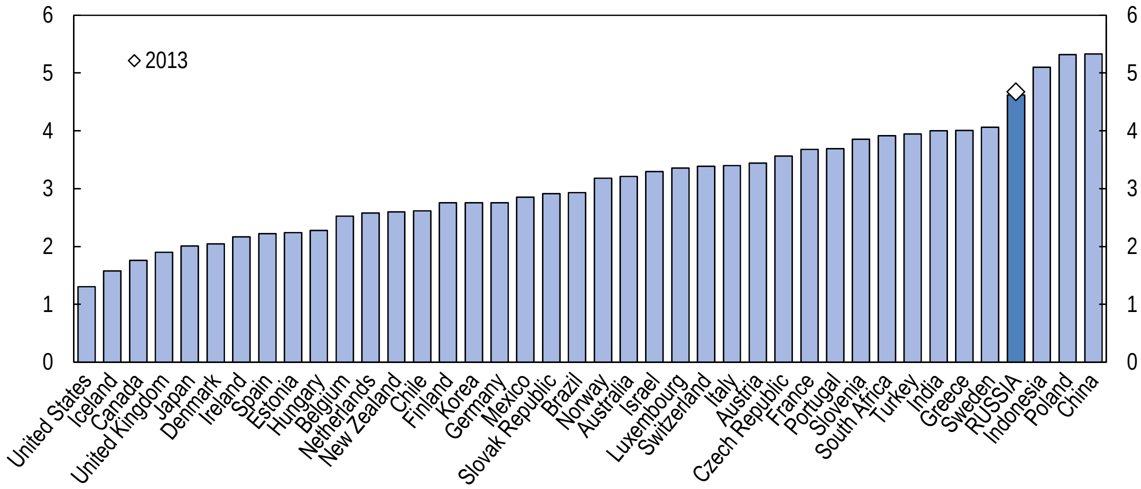
Today, the extent of State control in Russia is higher than in most countries[17] (Figure 2). The importance of the SOE sector in the current Russian economic model is perhaps larger than it was only a decade ago. BNP Paribas estimated that by 1999 the State ran less than 10% of total oil production, while by 2012 it controlled between 40 and 45%.[18]

[16] The market sentiment during that period of State expansion was vividly expressed by the 2009 prospectus of United Company Rusal Ltd, which noted that some "observers have also speculated that certain environmental challenges brought by Russian authorities in the oil and gas sector have been targeted at specific Russian businesses under non-Russian control, with a view to bringing them under State control" (p. 45).

[17] OECD (2014), *OECD Economic Surveys: Russian Federation 2013*, OECD Publishing.

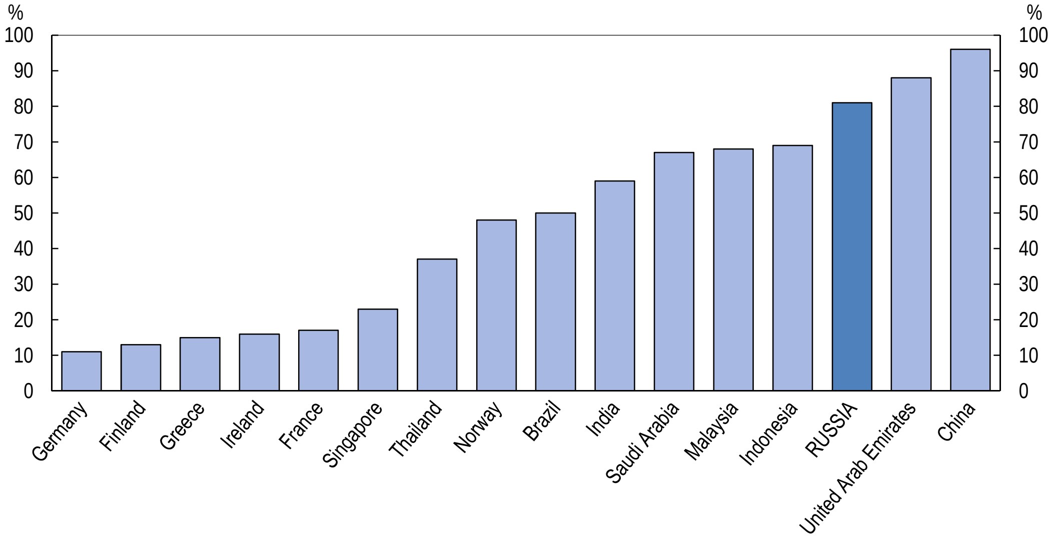
[18] BNP Paribas (2012), *Russia: The Land of Bountiful Giants*, by Julia Tsepliaeva and Yury Eltsov, 22 October 2012, BNP CIB.

Figure 2. Product market regulation indicator: public ownership
(2008 index scale of 0-6 from least to most restrictive)



Source: OECD, Economic Survey of the Russian Federation 2013. Note: The OECD PMR indicators are a comprehensive and internationally-comparable set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable.

Figure 3. State-owned enterprises shares among countries' top ten firms



Source: Kowalski, P. et al. (2013). Note: Unweighted average of SOE shares of sales, assets and market values among country's top ten companies. Only countries with shares above 10% are shown.[19]

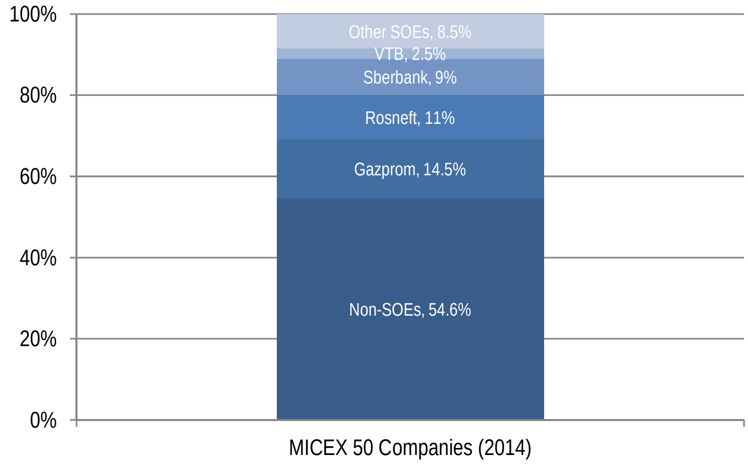
In comparison with others, some studies show that Russian SOE sector's share among the countries' top ten companies is particularly high, only topped by the UAE and China (Figure 3).[20] The Russian State is thus a prominent controlling shareholder, including in listed companies. Indeed,

[19] Please note that this methodology may be somewhat biased against countries with large banking sectors, which assets are financed with liabilities that are not included in the calculation.

[20] Kowalski, Przemyslaw et al. (2013), *State-Owned Enterprises: Trade Effects and Policy Implications*, Trade Policy.

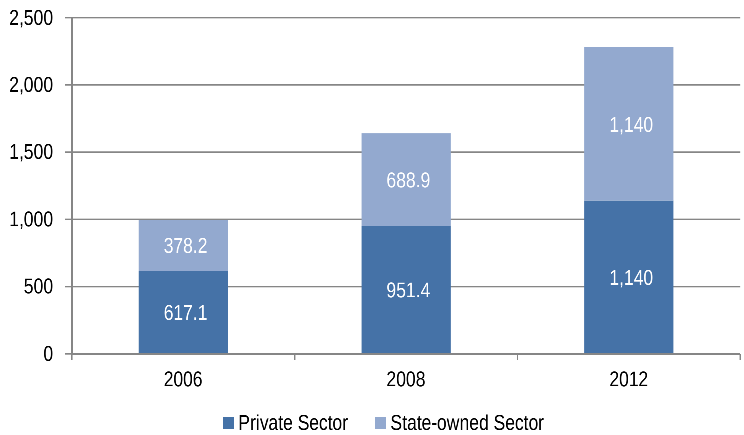
many of the largest listed companies in Russia are majority owned by the State. Since government-controlled companies tend to be the largest, SOE market value represents almost half of the value of market capitalization of the 50 companies of the MICEX 50 Index (Figure 4).

Figure 4. Breakdown of market capitalization - MICEX 50: SOEs vs. non-SOEs (2014)



Source: FactSet data, author's analysis.

Figure 5. Russian GDP breakdown (USD bn)



Source: BNP Paribas, 2012.

Suggesting a precise figure on the size of Russia's State-owned sector is however complex without comprehensive official statistical information and due to the remaining opacity of corporate structures and reporting. By 2008 the MED estimated that the SOE sector represented about 40% of GDP, and then suggested it might have gone up to 50% transitorily during the financial crisis. According to a BNP Paribas report (2012) it accounts for as high as 50% of GDP (Figure 5). Moreover, it is reported to be growing, as described above. Based on BNP data it can be concluded that the private sector has grown at a compound annual growth rate of 10.8% p.a. over 2006-2012, while the State-owned sector has outpaced it by growing at 20.2% p.a. over the same period.

BNP Paribas (2012), comparing Russian SOEs to foreign pairs, claims that efficiency in the SOE sector is lower than in the private sector, probably due to poor management but also because of State interference with day-to-day operations, particularly at the level of large and strategic SOEs. Labor productivity in the State-owned segment is estimated to be more than 30% below the national average. Agency problems and government interference may indeed have a strong impact on SOE performance.

An analysis of the return on assets (ROA) ratios of Russian SOEs in the oil & gas as well as in the utilities sector underlines that private companies outperform SOEs in terms of efficiency. The ROA ratio indicates how effectively the companies are deploying their assets[21] (e.g. how many rubles of earnings they derive from each ruble of assets they control). A low return on assets thus indicates less efficient management, e.g. one that does not strive to extract greater profit from every unit of assets at its disposal. It may, for example also hint to a heavy burden of non-commercial objectives imposed on SOEs. Likewise, the analysis of return on equity (ROE) ratios shows that Russian SOEs are broadly underperforming non-SOEs. As the ROE measures a company's efficiency at generating profits from every unit of shareholder's equity, it can be argued based on this ratio that non-SOEs tend to better use invested funds to generate earnings.

These inefficiencies, which are certainly not unique to the Russian SOE sector, but that may be perceived to be significantly stronger in Russia than in other OECD countries, is reflected in how Russian SOEs are valued significantly below their international peers. From the 10 largest SOEs listed on the Moscow Exchange none currently achieves a P/E ratio of above 7x and some price-to-book (P/B) ratios are particularly low, such as in the cases of Gazprom, Rushydro, Inter Rao and Russian Grids (Table1).

[21] ROAs over 5% are generally considered good. However, the ROA will vary widely across industries; it is hence useful for comparing competing companies in the same industry.

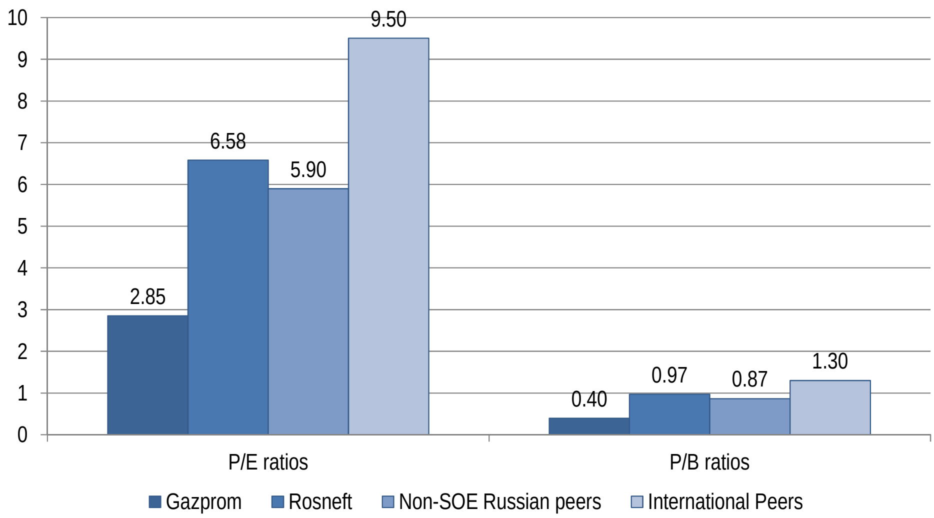
Table 1. Top 10 SOEs traded on the Moscow Exchange

Issuer	Market capitalisation USD million (2014)	Central government ownership (%)	P/E ratio	P/B ratio
Gazprom	100,481	50.1	2.85x	0.40x
Rosneft	75,761	69.5	6.58x	0.97x
Sberbank	61,930	50.1	6.09x	1.26x
VTB	16,976	60.9	5.88x	0.74x
Transneft	16,010	78.3	2.92x	0.43x
Rostelecom	9,173	55.6	6.63x	1.36x
Alrosa	7,868	43.9(*)	6.79x	1.57x
RusHydro	5,091	67.0	Losses	0.44x
Aeroflot-Russian Airlines	2,577	51.2	6.95x	0.87x
Russian Grids	1,981	85.3	Losses	0.43x

Source: Companies data, FactSet data and authors' analysis. Note (*): Considered a controlled SOE even though the central government holds less than 50% of shares because of the existing golden share in favor of the State.

Data from the oil & gas sector illustrates the phenomenon observed through all economic sectors: the valuations of Russian SOEs are significantly below those of international peers as they only trade at between 2 to 7 times earnings, while those peers are traded over 9 times on average (Figure 6).

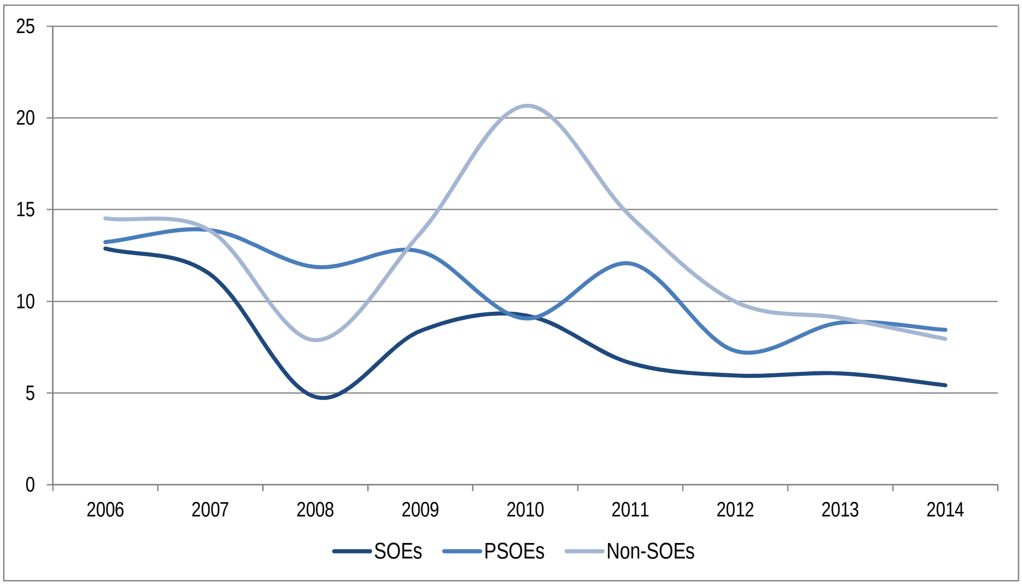
Figure 6. Valuations in the Oil and Gas Sector (2012)



Source: Companies data and authors' analysis. Note: International peers include Shell, Total, BP, Eni and Statoil.

However, time series of the last eight years evidence a declining trend of P/E ratios of all Micex 50 companies. Moreover, the P/E ratios of SOEs are constantly below those of non-SOEs implying an even more cautious attitude of investors towards SOEs' governance risk (Figure 7). In fact, the risk premium charged by investors on Russian shares, not only SOEs, is very high compared not only tom OECD countries, but also to similar BRIC countries. During 2013 shares traded in the Russian market at an average price of 5 to 6 times this year's earnings while the level of all other BRIC countries was higher on average: Brazil, 13x; India, 15x; China, 10x. This is particularly complex at a time the State has publicly announced that it is preparing many of these assets for privatization, as without improvement of these ratios via corporate governance reforms that encourage investors' trust, the Russian State will not obtain the full value of these SOEs.

Figure 7. Micex 50 P/E ratios 2006-2014, SOEs vs. Non-SOEs and PSOEs[22]



Source: FactSet data, authors' analysis. Unweighted average.

III. THE RUSSIAN STATE AS CONTROLLING SHAREHOLDER

The current and past governments have been publicly vocal about the size of the SOE sector and the need to improve its efficiency. For that they have announced privatization plans that could reduce the size of the State, associate private sector expertise with SOEs, create important opportunities for private sector activity in areas currently closed or subject to limited access and enhance the competitiveness of the Russian economy. In parallel, they have adopted some measures to improve

[22] In this chart, companies where the state holds between 10% and 50% of shares or votes are considered as PSOEs (partly state-owned enterprises). SOEs are all enterprises where the central government owns more than 50% of the shares or by other means holds effective control.

SOE management and strengthen the role of Rosimuschestvo, the Federal agency in charge of managing these State assets and promoting better governance among them.

Ongoing privatization efforts

In terms of design, the message from the Russian State has been quite clear in the sense that privatization is one of the pillars for the development and modernization of the economy. The privatization plan for the years 2011-2013, adopted in 2010, foresaw the privatization of 1,500 enterprises, including several large companies in key sectors, such as banking, energy, telecoms and transport. A presidential decree of May 2012 requested the full withdrawal of the State from most companies, except for natural monopolies and oil and defense sectors by 2016. These plans were revised in June 2012 and new privatization plans were adopted until 2016, foreseeing full privatization of large SOEs, such as VTB, Rosneft, Aeroflot, Rushydro, Sheremetyevo Airport and Sovcomflot, and a reduction of State ownership in RZD Russian Railways, Transneft and Zarubezhneft.

Many small SOEs were privatized according to these plans and large number of State stakes were sold, so that the number the State's stakes in unitary enterprises decreased from around 3,500 to 1,800 from 2010 to 2013. Likewise, the number of stakes in JSCs decreased from 3,000 to 2,300 over same period. Reportedly over 1,800 SOEs were still scheduled for full or partial privatization by 2013, including 638 unitary enterprises and 1,201 joint stock companies.

The privatization of large SOEs shows a less successful record. In September 2012 the State completed the sale of 7.6% of Sberbank, reducing the State control to just 50% plus one share. It also concluded the privatization of 50.1% of United Grain Company and the IPO of Alrosa and, more recently, issue new shares in VTB to foreign sovereign funds, which has reduced the State's stake in the bank from 75.5% to 60.9%. These are large transactions and they accounted for about 80% of the income of the government from privatization in 2012,[23] but they are far from the targeted numbers.

As noted by the 2013 OECD Economic Survey of the Russian Federation, the share of the SOE sector has not been reduced in size as a result of privatization, but has actually grown in recent years due to important acquisitions by large SOEs. Rosneft's purchase of privately owned TNK-BP, which made Rosneft the world's largest publicly traded oil company in terms of extraction and reserves, is a clear example. This acquisition was received with high levels of criticism from market observers as it might be an indication that the government opts for State capitalism over privatization and competition.[24] This sentiment was partly fuelled by the fact that the majority of large privatization transactions have repeatedly been delayed. According to official sources, the delays have been due to unfavorable market conditions, but even the Prime Minister has publicly mentioned the lobbying by "individual ministers and officials" against transactions "that would take away their control over a set of assets" as a barrier to privatization.[25]

Table 2. Privatization plan 2012-13 and until 2016 vs. privatization plan 2014-16

Company	State share in September 2013	Target state share under privatisation plan 2012-13 and until 2016	Target State share under privatisation plan 2014-16
Rosselkhozbank	100.0%	Full exit by 2016	No plans for privatisation
Sberbank	50% + 1	50% + 1 (reduction from 57.6%)	No plans for privatisation
VTB	60,9%	Full exit by 2016	50% + 1
Rostelecom	55.6%	Full exit by 2013	Full exit by 2016
Aeroflot	51.2%	Full exit by 2016	25% + 1 (probably full exit after 2016)
RZD Russian Railways	100%	75% + 1	75% + 1
Sovkomflot	100%	25% + 1	25% + 1
Sheremetyevo airport	83.0%	Full exit by 2016	Full exit by 2016
Vnukovo airport	74.7%	-	Full exit by 2016
Rushydro	67%	Full exit by 2016	50% + 1
Rosneft	69.5%	Full exit by 2016	50% + 1
Transneft	78.3%	75% + 1	75% + 1
Zarubezhneft	100%	Full exit by 2016	50% + 1 share

Source: OECD Economic Survey (2014).

[23] OECD, 2014.

[24] Guriev and Tsivinsky (2012), *Sechin and the Commanding Heights*, Project Syndicate Open-Ed.

[25] The Moscow Times (28 June 2013), *Cabinet Scales Back Privatization Plan*.

While the reluctance to sell State assets below fair value is understandable, there is a risk that privatization may be systematically postponed. This hypothesis is underscored by a substantially more modest privatization plan for 2014-2016 announced in the summer of 2013 (Table 2). Among the main changes is the decision to retain VTB, Rosneft, Rushydro and Zarubezhneft under State control until at least 2016. Further partial privatization of Sberbank within the planning period was also ruled out. It remains to be seen to what extent the new plan will be implemented and the how much the size of the SOE sector will be reduced.

Reform initiatives

Considering the pace of privatization so far and taking into account that even after their completion the State will remain a controlling or blocking-minority shareholder in many firms, improvement of the governance of the SOEs is a key challenge for the Russian Federation going forward. This is something the Russian authorities have publicly declared repeated times, often accompanied from new decisions and support for the activities of Rosimuschestvo, the Russian ownership agency.[26]

Rosimuschestvo and other authorities, including the Ministry of Economic Development and the Bank of Russia, have been active in recent years improving the corporate governance of SOEs. A special focus has been put on access to SOE performance information, which is essential to set goals and demand accountability, as well as in improving the composition of SOE boards. More recently, listed SOEs have been required to upgrade their listing level at the Moscow Exchange, becoming fully obliged to comply-or-explain regarding the new Code of Corporate Governance and to follow the revised listing requirements.

To improve the efficiency of State holdings, special committees were introduced and key performance indicators will now have to be adopted in line with the strategy defined for each SOE.

[26] The Federal Agency for Government Property Administration was established in 2004 to execute the ownership function in SOEs on behalf of the Russian State. The Agency reports to and is overseen by the MED. For State-owned JSCs, Rosimushchestvo is in general designated as the legal owner of the shares.

Rosimuschestvo has increased its presence in the selection of board nominees by enrolling the assistance of several director associations, which propose their members to different boards.[27] However, particularly regarding "special list"[28] large SOEs, Rosimuschestvo's board nominations are reportedly overruled often at the government level. This, together with occasional interferences from sectorial ministries, undermines Rosimuschestvo's ability to promote better board appointments.

However, the professionalism and independence of boards has also been targeted by a Presidential decision of 2011 to withdraw top level public officials from the board of SOEs and the appointment of more independent directors.[29] This in particular was viewed as a significant step forward, aiming to decrease political influence at the board level, even if some of the directors that replaced political level figures are still subject to the "system of instructions",[30] under which they are required to vote at board meetings according to the State's preferences on a set of issues.[31]

[27] Critical voices see a risk in this practice as some of these organisations are allegedly not subject to stringent requirements in terms of their own functioning that could guarantee the quality of their candidates, such as transparency on membership criteria, governance requirements and accounts.

[28] The "special list" is an internal classification of the Russian government, defined by Government Decision # 91-p that defines a list of companies that are partly or totally removed from Rosimuschestvo's control and handled directly from government, where the Prime Minister or Deputy Prime Ministers act as the final decision-making bodies.

[29] In a survey conducted by KPMG in 2011, positive changes on corporate governance practices of SOEs are highlighted, particularly the importance of having independent directors on their boards. The survey recounts significant progress in recent years contrasting that at the beginning of the period most boards had no committees, there were no agendas for meetings, and voting by board members was rather a formality than exercise of monitoring, with the vast majority of government officials not devoting much time or efforts into their work on boards. KPMG (2011), *Practices of Corporate governance in Russia: defining the national model, expert analytical report*, Moscow, 2011.

[30] The issues for which instructions are issued include: i) approval of the agenda for the shareholders' general meeting; ii) increase of charter capital; iii) election of executive body and termination of executive body's capacity ahead of time (both only if it is in the competence of board of directors according to the charter); iv) recommendation to general meeting on the level of dividends; v) approval of the major transactions; vi) company's participation or termination of participation in other organizations (if it is not competence of executive body according to the charter), and vii) election and re-election of the chairman of the board of directors. Also, instructions may be issued for issues related to fulfilling orders of the President, the Prime-Minister and First Deputy Prime-Minister of the Russian Federation. The use of this system of instructions has been accompanied with some sort of informal indemnity agreement, whereby the directors are assured that they will not be held liable, or will be indemnify by the State, in case they follow their instructions and damages are caused to the company or other shareholders. The liability is therefore transferred to the person or authority issuing the instruction (shadow directors).

[31] A paper describing such efforts in detail is being published together with this article, so they will not be further discussed here.

Public efforts are also targeted along a number of other crucial areas for development: streamlining the SOE sector with regard to SOE's legal forms, developing a clear ownership policy for the SOE sector, promoting higher levels of listing and implementation of the new Russian Corporate Governance Code. The planned simplification of the SOE ownership models is a reasonable step forward, as currently the sector is still characterized by many different company types (including State unitary enterprises, State corporations, JSC and others). These varying corporate forms reduce transparency and accountability, as well as complicate the regulatory framework and the unbundling of the commercial and non-commercial roles of SOEs. A harmonized management model would require streamlining and the authorities have considered introducing the JSC as a dominant model for all SOEs with commercial objectives. For other cases they have designed a "public law legal entity" form which will deal with SOEs with public function objectives.

Some of these initiatives have been applied to all SOEs, while other have affected them unevenly, as some companies included in the "special list" have at times managed to be spared from reform. Some of these companies are regarded as strategic, and the authorities seem to want to keep a firm grip into their day to day operations, rather than to define clear mid-term mandates for them to accomplish through professional boards and managers, with enough independence and accountability. International experience suggests that it is often a bad policy choice to nominate CEOs that benefit from direct and personal links to the highest levels of power, which they may use to oppose, and at times defy, the authority of the government officials defining SOE policy. Such situations mostly lead to a lack of sufficient accountability to proper institutions, often resulting in mismanagement and harmful corporate governance practices, like empire-building and self-dealing, if not to higher risks of corruption. Furthermore, in such cases the board often does not have the authority to appoint and remove the CEO, and therefore its effectiveness is limited.

The abovementioned corporate governance reform initiatives may help provide the necessary impulse improve investor confidence in SOEs, and by extension, in the Russian capital market. Key still pending reforms, such as in the areas of related party transactions and takeovers,[32] could be developed in parallel and contribute to boosting investor's confidence. Properly done, this could also have an effect on improving the business climate, reducing the chances of corruption and promoting the development of the Russian capital market, in line with the aspiration of the Russian authorities to promote Moscow as an international financial center.

One of the biggest challenges, naturally, is to convince investors that these efforts will enhance the protection of minority shareholders, an area where the State does not have the best reputation as controlling shareholder. According to Sberbank (2013), SOEs have a poorer track record of looking after the interests of minority shareholders than any other group of companies, considering their ownership structure.[33] Prominent recent examples include a targeted share buy-back plan at double the market price aimed only to certain domestic retail investors, which was requested from VTB by the highest levels of political power, as well as the refusal by Rosneft to launch a tender offer to TNK-BP minority shareholders at the same price it paid to acquire control of the company. Sberbank argues that misbehavior by the State on corporate governance is due to the fact that the State has many other constituents to please apart from investors. A BNP Paribas report (2012) points also at a "blurred line" between the State-owned sector and the federal budget, highlighting the non-commercial objectives of SOEs, like their funding of non-profitable investment projects sponsored by the government. This arguably is a remainder for the Soviet era where many SOEs were actually ministries (like Gazprom) or had significant social and public obligations.

However, Sberbank (2013) also suggests that there are significant potential gains for the entire market, but particularly for State, that could be derived from a reduction of investors' perception of the risk of doing business with Russian SOES. In some cases this could more than double current valuations. This of course would require a sustained change in the perception of risk in the Russian

[32] For an example, see Dmitri Lovyrev (2012), *Legal Issues with Acquisition of Major Stakes in Russian Companies*, OECD Russia Corporate Governance Roundtable.

[33] Sberbank divides listed companies in four groups considering their ownership structure: dispersed ownership; controlled by a group of large shareholders, controlled by a large private shareholder, and controlled by the State.

capital market so as to reach the level of comparable emerging markets. Meeting that goal would, in turn, require re-doubling current efforts and, perhaps equally importantly, avoiding new prominent cases of SOEs mistreatment of investors. How to achieve this is the key. A robust corporate governance framework relies on institutions and practices that build a system where potential misconduct is faced with multiple obstacles, ideally up to a the point where it is finally discouraged. Such a framework must be carefully built to avoid loopholes (or to close existing ones), must induce good levels of compliance via incentives and must be actively monitored and strongly enforced by well-resourced and powerful regulator.

IV. RECOMMENDATIONS FROM OECD STANDARDS

The following paragraphs highlight two of the main areas where the recommendations from the OECD standards could be useful for the better functioning of SOEs in Russia: the roles of each the State and the board. The most relevant source for this advice are naturally the OECD Guidelines on Corporate Governance of State-Owned Enterprises (hereinafter the Guidelines), which exist to help States improve the governance of SOEs in the face of difficult challenges. A first challenge is to find a balance between being an active owner while shielding the companies from undue political interference. A second challenge resides in obtaining effective accountability on the performance of its SOEs, given that they involve a complex chain of agents with often unclear, remote and uncoordinated principals. States also need ensure that SOEs compete with private sector companies on a level-playing field, without advantages or disadvantages driven by their public ownership. The recommendations of the Guidelines aim to overcome these challenges and foster a sound policy framework.

Role of the State

Overall, the Guidelines recommend that the State should act as an informed and active owner, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness. It is commonly understood that for this the State has to develop a clear and consistent ownership strategy, a structured board nomination process and an effective exercise of established ownership rights.

The Guidelines recommend that the government should not be involved in the day-to-day management of SOEs and should allow them full operational autonomy to achieve their defined objectives. This does not mean that States as controlling shareholder should let SOEs alone to define their objectives. No controlling shareholder does that, so the political economy of implementing these governance practices is a challenge in itself. Perhaps one of the keys for success is that there are different means for the State to define and communicate its expectations to SOEs. In choosing those means that build lasting functioning institutions, that are predictable and that foster investors' confidence, States can contribute to a better governance framework without surrendering their legitimate ownership rights and expectations.

In this area of ownership policy, the Guidelines recommend that governments should define who, within the State, will exercise ownership rights; what are the general policies as to why is it that the State owns enterprises; what is expected of them and weather privatization is foreseen. These general policies should be reflected into specific mandates for individual SOEs, describing the concrete expectation of the State as controlling shareholder and the strategic orientations it would like each relevant SOE to pursue.[34] Making these documents public and revising them at regular intervals, contributes to fostering stable and accountable frameworks.

Naturally, and mostly at the beginning of the process, it may not be easy for a State to accept to relinquish full control over SOEs, particularly if they have been used to address contingencies or to

[34] OECD (2010) publication *Accountability and Transparency: A Guide for State Ownership* offers step-by-step recommendations on how to develop these documents.

develop public policy objectives in combination with, or as a substitute of, the State's administrative organs. The Guidelines recognize that SOEs could be required to fulfil public policy responsibilities beyond the generally accepted norm, but asks for them to be clearly mandated by laws or regulations, disclosed to the public and accounted for in terms of cost and sources of funding. Investors then know what to expect and managers can be held accountable taking these factors into account. In some cases, the State also plays a dual role of market regulator and owner of SOEs with commercial operations in those specific markets. This turns the State into a major market player and an arbitrator, leading to irresistible conflicts of interest and discouraging private participation of those markets. Full administrative separation of responsibilities for ownership and market regulation is therefore a fundamental prerequisite for creating a level playing field for SOEs and private companies and for avoiding distortion of competition.

Appointing an effective board is the second crucial stage. Being a controlling shareholder, the State is in position to nominate and elect a majority of the board, often without much interference from minority shareholders. This legitimate right comes with a high degree of responsibility for identifying, nominating and electing board members. The Guidelines recommend that this process be formalized, and that in structuring it the State should consider existing best practices.[35] Clear ownership policies and mandates for individual SOEs should be entrusted to individuals capable of executing them with integrity and professionalism, being fully accountable for their performance.

Empowering and improving the quality of SOE boards is a fundamental step in improving the corporate governance of SOEs. Only a strong board can effectively monitor management for the fulfilment of the company's strategy, which is crucial if the SOE is to deliver the State's targets for the company's performance. For these reasons, the Guidelines imply that the ownership entity should avoid electing an excessive number of board members from the State administration, particularly in listed SOEs and for SOEs in competitive industries. They would often not have the preparation or the

[35] See, for example, OECD (2013), *Boards of Directors of State-Owned Enterprises: An Overview of National Practices*, OECD Publishing, or Kostyleva, Valentina and Héctor Lehuedé (2012), *Board Formation: Nomination and Election in OECD Countries and Russia*, OECD Russia Corporate Governance Roundtable.

time, on top of their public duties, to perform at the level required of a board member. Likewise, it is important that individual board members when they carry out their duties do not act as representatives for different constituencies. All board members should carry out their duties in an even-handed manner with respect to all shareholders.

With a clear ownership policy in place and a strong and professional board in charge of approving strategy and monitoring management, it is easier for SOEs to provide equal treatment to all shareholders and better respect minority rights. This is essential where SOEs are listed or otherwise include non-State investors, since the State's reputation as owner influences its capacity of attracting outside funding when needed, as well as the valuation of the companies it may want to privatize. Moreover, considering that investors may distrust their chances to obtain redress from the domestic courts litigating against the State, investor's tolerance for conflict in SOEs is often lower than in privately-owned firms. States therefore can do great progress by showing they are not opaque, unpredictable and unfair controlling shareholders.

Role of the board

In general, SOE boards are expected to: (i) approve, monitor and review corporate strategy, within the framework of the overall corporate objectives; (ii) establish appropriate performance indicators and identify key risks; (iii) monitor the disclosure and communication processes, ensuring that the financial statements fairly present the affairs of the SOE and reflect the risks incurred; (iv) assess and follow management performance; (v) develop effective succession plans for key executives. However, the practice in ownership agencies and SOEs around the world shows that in many cases boards are not able to perform all these functions because they were never given the means to do their jobs properly. They were not granted full responsibility and the authority for strategic guidance, within the range of options offered by a clear ownership policy, nor had the capacity to monitor management and control performance.

In some cases, the ownership agency, if not the government itself, may be tempted to become too involved in the board's decision making process, blurring the line between defining objectives and implementing them. The Russian practice for a "system of instructions" under which voting instructions are issued to some SOE board members, is a perfect example of this conduct.[36] In other cases boards may encounter difficulties in monitoring management as they do not always have the authority to do so, as the power for appointment and dismissal of the CEO may be reserved for the political authorities. In these cases, SOE senior management could behave as if they report directly to the ownership agency or the high level government officer who appoint them, thereby circumventing the board. Alternatives exist, even within this complex setting, to have the board's voice heard in the process. In some jurisdictions there is the obligation to request the opinion of the board about the continuity of the CEO, often accompanied by the obligation of the State to explain if it does not follow the board's advice. In some other circumstances, the board is charged to prepare a short list of candidates, from which the State can then choose the CEO.

On top of empowered boards, it is necessary to ensure the competency of board members, foster their independence and strive towards improving their collective functioning. A central requirement to enhance the objectivity of SOE boards is to nominate a sufficient number of competent non-executive board members who are capable of independent judgment. These board members should have the relevant competence and experience and it is advisable that they be recruited from the private sector, particularly for SOEs that operate in competitive markets. Their expertise could also include qualifications related to the SOE's specific obligations and policy objectives. In some countries, diversity in board composition is also an issue and it includes gender consideration. The setting up of specialized board committees could be instrumental in reinforcing the competency of SOE boards and in underpinning their critical responsibility in matters such as risk management and audit. Evaluation

[36] Regardless of its exact nature or its legal obligations, directors seeking to act in the best interests of the SOE will inevitably run into conflicts with their duties to act in accordance with these instructions. In a situation like this, it is hard to find real exercise of independent judgment at the board. For wholly-owned SOEs and unitary enterprises, having government providing detailed instructions reduces the board to a formal role, while for partially-owned SOEs, State representatives operating under instructions effectively become advocates for government-derived policy, rather than stewards of the company, putting minority shareholders' interest in jeopardy.

and self-evaluation, as well as induction programs for new members can go a long way in facilitating team work, but it is often after the Chairperson to set the tone from the top as how the board will operate within the functions provided by law, the company's charter and internal policies. All this is reinforced by demanding rules requiring board members to disclose any conflicts of interest to the board which must define formal procedures to manage them.

SOE boards should, in principle, have the same responsibilities and liabilities as privately-owned companies, the collective and individual liability of board members should be clearly stated. All board members should have the legal obligation to act in the best interests of the company and to treat all shareholders equitably. Furthermore, there should not be any difference between the liabilities of different board members, whether they are nominated by the State or any other stakeholders.

Conclusion

The presence of an effective corporate governance system within an individual company, and across the economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. Given the role of the State-owned sector in the Russian economy, a strong corporate governance framework has important implications for economic growth and development. In consequence, reforms of the corporate governance of SOEs could become a key driver of potential economic growth and development for the Russian Federation.

When the Russian government approved its new Corporate Governance Code, in February of 2014, Prime Minister Medvedev highlighted that the Code was adopting international best practices on corporate governance[37] and confirmed that SOEs should be among the first to effectively implement the provisions of the Code. He underlined that the government is fully supportive of the wide-ranging implementation of best practices of corporate governance in SOEs, which according to the Prime Minister, should lead by example.

[37] The Prime Minister's statement is available at: http://government.ru/meetings/10473/stenogram.

This sets a high bar for the SOE sector, but most of the elements necessary for achieving this ambition are now in place. The corporate governance framework has been reformed to close many of the loopholes (although a few prominent problems remain) and the Code is aiming to offer some soft-law responses in areas where it has been impossible to adopt legal reform and following international standards. The merger of the Federal Service for Financial Markets into the Bank of Russia has created a strong and resourceful regulator, which in collaboration with Rosimuschestvo and using the Code, can now induce good levels of compliance among SOEs, particularly the largest and listed enterprises. The Bank of Russia and Rosimuschestvo are also in a position to actively monitor and strongly enforce good corporate governance practices. This is a promising setting that should inspire all concerned parties to reap all the benefits that improved governance of SOEs can bring to the Russian economy.