I. Summary

1. The second meeting of the Corporate Governance Roundtable for Russia took place in Moscow, on 24-25 February. The discussion focused on shareholder rights and equitable treatment, following a consensus by participants in the first Roundtable meeting last June that this is a priority issue. The Roundtable includes as members, senior representatives of key Russian institutions and in particular the Federal Commission on the Securities Market (FCSM), the Supreme Arbitrazh Court and the Coordination Centre for Investor Protection. The meeting was co-sponsored by the OECD, World Bank Group and the Centre for International Private Enterprise (CIPE).

2. The presence of over 100 participants from across the Russian Federation, OECD countries and other international organisations attests both to the importance of the subject to long term economic growth in Russia as well as the need for a continuous dialogue on corporate governance. Through this dialogue between investors, corporations, judges, regulators, market practitioners, civil society, foreign and domestic experts, the Roundtable participants contributed to promoting reforms by building mutual understanding and confidence while learning from each other’s experience. The dialogue used the OECD Corporate Governance Principles as a conceptual framework in order to help Russia develop its own solutions.

3. It was recognised that some aspects of the regulatory framework for corporate governance has significantly improved in Russia with a relatively sound company law, investor protection regulation, increasingly stronger securities law and emerging investor protection organisations. The emphasis is now on their implementation and enforcement by the state and private sector institutions. Minority shareholders have suffered in the Russian post-privatisation environment which is rampant with abusive self-dealing such as asset stripping, transfer pricing and share dilutions. These practices are often perpetuated by either management or controlling shareholders in corporate groups to the detriment of minority shareholders and the development of equity markets. Shareholder protection is an important pre-requisite for shareholder voice. In its turn, the exercise of shareholder voice is essential when investors cannot exit the market, as in Russia, due to low liquidity. The availability and enforceability of legal remedies for shareholders need to be improved in order to develop a predictable environment for investors.

4. The Roundtable focused on the rules, procedures, practices and institutions for protection of shareholder rights in Russia. While the legal framework for corporate governance provides a sound basis, there are some important gaps, for example, the lack of civil and criminal liability provisions of managers for abusive self-dealing. To improve weak enforcement, it is important that the higher judicial authorities increase efforts to interpret the law and give guidance to lower courts so that their decisions are more consistent. The FCSM should be encouraged to continue applying its recently acquired power to impose sanctions more aggressively and take on additional responsibilities to ensure the application of equal treatment principles.

5. Legal remedies are not the only way to improve protection of minority shareholder rights. Self-regulatory organisations of market participants and stock exchanges have a major role to play. They have
all been severely affected by the 1998 financial crisis. They can do more to ensure the integrity of the securities market and the credibility of their own members and institutions. Professional bodies such as lawyers and auditors/accountants can help by performing their task diligently and with responsibility when examining the company charters, bylaws, financial statements, balance sheets, and contracts. Civil society and in particular, the media can act as a powerful agent for building public understanding of corporate governance issues and by providing external monitoring.

6. Most importantly, the Russian corporate sector needs to be convinced that the development of robust outside financing, both foreign and domestic, is a key source of future growth and development. Asset stripping, transfer pricing, dilution and other self-dealings have given Russian companies and the market a bad image. In this respect, the increasingly large stakes acquired by management in major Russian corporations might be a potential incentive towards increasing shareholder value in those corporations. Companies are encouraged to make public commitments and measure up to internationally recognised corporate governance principles on basic shareholder rights and equitable treatment.

7. Corporate governance reform has an important positive spill over effect on the economy and society. The involvement of a vast constituency of public and private sector players makes corporate governance a powerful engine for change, a change that might impact on many areas of private and public life. However, the results of corporate governance reforms cannot be expected to emerge overnight, as ultimately they involve cultural change. The forthcoming work of the Roundtable, its dialogue meetings, preparation of the White paper and analytical work will be used to help keep the issue at the centre of reforms for as long as needed to achieve this cultural shift.

Participants engaged in a lively discussion on the Roundtable’s future work and agreed to adopt the proposed work programme, its objectives and the following action plan for the year 2000 (pending available resources):

- To draft and endorse a White paper setting out detailed recommendations on corporate governance in Russia, using as a framework the OECD Principles of Corporate Governance. The first draft of the White paper will be discussed in October 2000;
- To hold the third meeting of the Roundtable in October 2000, focusing on issues of transparency and disclosure. This will include a review of internal and external audit procedures, as well as the enforcement of disclosure regulations and laws, their impact on the market and the economy at large;
- To develop analytical work within the next twelve months on the corporate restructuring in the Russian industry through mergers and insolvency related re-organisation;
- To facilitate private action by major Russian corporations in committing themselves to improve corporate governance in a credible and verifiable way;
- To help develop a corporate governance website for Russia, within the first six months of 2000, in order to facilitate the dissemination of corporate governance-relevant information for Russia; and
- To assist the Supreme Arbitrazh Court in publicising and disseminating its decisions and guidelines.

The following Note attempts to summarise the important policy issues that were raised during the discussion and in the meeting materials, outlining a number of the main conclusions. It is drafted under the responsibility of the OECD Secretariat and will be used as the basis for preparing the first chapter of the draft White Paper.
II. Main results: conclusions and recommendations

The framework and infrastructure for property rights enforcement

8. The discussion on shareholder rights began by reviewing the framework and infrastructure for property rights enforcement in Russia. Participants examined the rules and procedures for the registration of ownership and transfer of shares, as well as the role of registrars, depositories, custodians and clearing settlement agencies in their implementation. The discussion highlighted some of the main constraints to enforcement.

9. PARTAD, the self-regulatory organisation responsible for the supervision of professional registrars and depositories, has the authority to assist the FCSM to oversee the implementation of regulations related to the sale and transfer of securities. A major obstacle to an efficient process is the lack of coordination between state institutions responsible for enforcing these rights and the professional community. This has resulted in inconsistent laws and procedures. It is important that PARTAD and FCSM continue efforts to harmonise procedures and strengthen oversight, in consultation with professional market participants.

10. In the past, cases of manipulation and fraud in company registries were flagrant, jeopardising effective ownership transfer and underlining professional irresponsibility. The problem is still not solved, especially in the regions. Currently, joint stock companies with less than 500 shareholders are authorised to maintain their own registries. Amendments to legislation have been proposed, requiring joint-stock companies to transfer their registers to professional independent registrars. This is likely to reduce cases of manipulation, help enforce more strict procedures and hopefully shorten time delays. Measures by PARTAD to improve monitoring procedures of its members and introduce requirements to improve professional standards are a positive sign.

11. Technical constraints, delays and lack of uniform procedures for settlements of securities transactions are hampering an efficient ownership registration process and therefore market liquidity. Introducing electronic means for the transfer and registration of securities may significantly improve the situation. A Transfer-Agency Centre was established in September 1999 by a group of major Russian registrars, representing property rights of up to 70% of the blue-chip market. It is anticipated that this will reduce transaction costs, improve transparency of settlements and efficiency of inter-depository transactions through its planned electronic network linking all existing registrars. This is expected to be the first step in creating the necessary technological conditions for the development of a central depository.

12. During the last few years, many investors have expressed the desire to see the establishment of a central depository in Russia in order to enhance the efficiency of the ownership and registration system, eliminate some of the transaction costs and reduce delays. Previous efforts to establish a central depository have failed due to a lack of support from the government. Market professionals remain divided on the institutional status of a central depository and its specific function. However, there seems to be a consensus that overall, the creation of a central depository might significantly improve the efficiency of the system and minimise abuses.

13. The FCSM issued a regulation authorising the creation of a centralised database, the “Central Data Depository”, which will come into force in July 2000. The new centralised agency will collect, maintain and process securities information, such as quarterly and annual financial statements as well as report on compliance. In principle, this is a positive step. It remains to be seen, however, whether the creation of a centralised database will effectively address long-standing investor concerns over irregular and inaccurate information.
14. The procedures for annual general meetings (AGM) as well as shareholder representation and voting practices in Russia were reviewed. The discussion focused on identifying the main gaps in notification and registration for participation in the AGM, voting rules/procedures, proxy mechanisms, and absentee voting.

15. Shareholders should have the right to actively participate in and be sufficiently informed on decisions concerning fundamental corporate changes. As most modern corporations worldwide, many large Russian companies such as Gazprom and United Energy Systems are faced with the challenge of managing relations with thousands of shareholders and this in a context of significant corporate restructuring. The Russian Company Law provides detailed rules on the procedures for calling and conducting an AGM, which seem to meet international norms. However, in practice, a number of systematic violations of procedures have been reported. The most prevalent has been the failure to give a shareholder adequate notice, if at all, of the time and location of the AGM and notification of the agenda.

16. Two case studies were presented on Surgutneftegas and Yukos that illustrate the problems with AGM participation. In the case of Yukos, Russia's second-largest oil company, management has been accused of intentional delays in sending out ballots and other documentation, which is often received after the voting date. In the past, the company agreed to amend its charter, transfer assets, and engineered a closed placement of its oil-producing subsidiary’s shares with offshore companies by side-stepping the consent of its minority shareholders. The latter were stopped from participation in the general meeting through a combination of delays and false procedural pretexts.

17. To help companies and shareholders better understand the legal requirements in advance of the meeting, AGM procedures should be made more precise and clear to all relevant parties in advance. The media and specialised journals can play an important role in ensuring wide dissemination of information on the AGM, including the location, date, time and agenda of the meeting. To allow for broader participation by shareholders, companies need to consider holding the AGM in a more central location. It is also important that the company adequately displays rules, procedures, and deadlines for voting so shareholders have clear instructions. Extending the current thirty-day notification period, in view of the large geographical distances in Russia and delays in the postal system, would allow shareholders to make more informed decisions.

18. An open and fair mechanism for proxy and absentee voting can contribute to improving corporate governance in Russia by allowing shareholders to participate in decision-making. With the increased importance of foreign shareholders, many OECD countries are in a dynamic process of improving their proxy voting systems. This includes, lowering often-cumbersome requirements such as notarisation of proxies in the country where the company is established. Secure electronic means of voting have become very popular among shareholders and companies welcome this more cost-effective method. As electronic mail is not widespread in some Russian regions, companies may also want to extend the period for processing voting ballots by mail.

19. A number of Russian companies have raised equity on international capital markets through American Depository Receipts (ADRs) and Global Depository Receipts (GDRs). However, there is a concern over the fact that foreign depositaries, as a matter of contractual practice, do not consult with shareholders before handing-over proxies to management. This is a questionable practice in the Russian context, depriving investors of already hard-to-come-by voice. In OECD countries, there is a growing trend to remove provisions that automatically enable custodians to vote the shares of their beneficiaries.
Rules are being revised requiring depositories to inform shareholders of all their options in the use of their voting rights. As ADR programmes become more popular in Russia, an accountability mechanism can be introduced to ensure that foreign depositories consult with shareholders before automatically transferring votes.

Disclosure of information on affiliated parties

20. The disclosure of information on affiliated parties of joint stock companies is one of the pivotal issues in the equitable treatment of shareholders. Ownership and control structures should be fully transparent to allow all outside shareholders to properly assess how control is exercised and evaluate their interest in providing equity finance. A number of amendments to the Russian Company and Securities legislation have been proposed to eliminate loopholes. But continuous changes and an uncoordinated institutional approach have created a fairly confusing regulatory framework. These often-contradictory provisions that are scattered across different regulations have lead to major drawbacks in their implementation and have resulted in weak enforcement. Confusion often arises from inconsistent requirements, which may mislead investors. The FCSM is encouraged to continue its efforts to work closely with related government agencies and the parliament in drafting amendments to legislation to make sure the regulations are consistent and enforceable.

21. Russian regulations require companies to disclose shareholders owning 5% of shares or votes, but the definition of affiliated persons in Russian law is vague. Information on affiliates is not always accurate or complete as reporting depends almost entirely on the good faith of the affiliated parties who are required to notify the company of their share purchase. The recently adopted FCSM regulation on affiliated parties attempts to close loopholes in the Company law which was not enforced until the Competition Law defined affiliated parties and the Commission devised reporting procedures for disclosing affiliates. In accordance with this procedure, a company and its managers are required to keep registries of affiliated persons and to disclose them at their shareholder’s request and within 10 days at a price under production cost. The adoption of the draft law on Affiliated Parties may help reinforce this regulation, which might be an important step in broadening the definition of affiliated party and giving more authority to regulators to suspend unlawful transactions. It remains to be seen whether sanctions will be imposed for violations of the procedures.

Cases of abusive self-dealing: asset stripping, share dilutions

22. Affiliated party transactions and major transactions (i.e. transactions that involve a large part of the company assets, irrespective of the parties involved) have been especially problematic in Russia. The Company Law provides for shareholder approval of major transactions (or unanimous BoD approval when the value is less than 50% of the book value), however the provisions are vague and do not provide sanctions for violations of approval procedures. Case studies on Yukos, Vyksa Steel Works, and Sibneftegazpererabotka (SNGP) illustrated some of the most prevalent abusive self-dealing practices by companies involving affiliated party and major transactions. These companies tried to dilute minority shareholdings through new share issuance, using a loophole in the company that bypasses pre-emption rights. For example, Vyksa issued new shares, under closed subscription, equal to 82% of the company’s chartered capital without the consent of its minority shareholders. Asset stripping during interested party transactions is also quite widespread. SNGP is a case in point: the company diverted substantial cash flows most probably controlled by its controlling shareholders, from its affiliate to a new company.

23. Given the widespread use of offshore corporate vehicles to divert assets or cash flows from companies to affiliated parties (i.e. management or controlling shareholders), Russian policy makers might consider making it easier for minority shareholders and companies to seek legal redress. One way of doing this could be to allow the annulment of affiliated party transactions on the basis of circumstantial
24. Another key minority shareholder right is appraisal, i.e. the right to sell their shares to the company, when fundamental corporate changes occur without their consent. However, as seen in practice, this right is hard to enforce without an independent appraisal mechanism to ensure that shareholders get a fair buy-back price. In most of the cases, management offered to purchase shares of dissenting shareholders based on a severely undervalued buyback price determined by an independent appraiser. Increasing the liability of the appraiser for an impartial estimation of fair market value might be a step in the right direction. It may be introduced using similar means as those of the 1999 Investor Protection Law, which holds the appraiser accountable for inaccurate or misleading information in a prospectus. Some OECD countries have referred the determination of a buy-back price, in the event of a squeeze-out situation or merger, to a professional arbitrator who is paid for by the company. This has produced a fast and reliable procedure at a reasonable cost. The incentive for the company is that the validity of the underlying fundamental corporate change is not questioned but only the buy-back price. This may be a useful mechanism for Russia, offering a more objective and fair appraisal process.

25. Many investors in Russia remain frustrated in their efforts to push for better corporate governance in order to eliminate affiliated party transactions in companies with significant state ownership. The role of the state as a major shareholder in many large corporations is problematic as company management often influences state representatives on the board. At present, there is little predictability as to how the state will manage its holdings. In many OECD countries the trend has clearly been to use the state holdings as a tool for introducing further transparency in corporate governance arrangements. Hence, the state as a commercial asset manager should become the most transparent owner of assets. Ensuring representation by independent directors is the only way of doing this. Furthermore, in Russia, transparent privatisation procedures are very important in order to restore the image of the insider deals that prevailed as a method of state asset disposal.

Legal remedies for shareholders

26. While regulation should protect all shareholders from expropriation, such transactions will inevitably occur. For this reason, adequate legal remedies for violation of minority shareholders’ rights at a reasonable cost and without excessive delay are key in enhancing overall investor confidence. Their impact is much more important than the actual amount of litigation, generating and building confidence into the corporate governance system.

27. The Russian Company Law offers a number of legal remedies for recourse to minority shareholders. These include an appeal against a resolution adopted by the AGM, the possibility to seek the annulment of a major transaction, and a suit seeking the invalidation of a transaction involving a conflict of interest. The possibility to file a derivative suit (i.e. on behalf of the company against the company directors) is also available, to shareholders holding at least 1% of common stock. However, there are severe problems with adjudication and enforcement by the courts.

28. The courts admit only documentary evidence, which is rarely available, given limited discovery possibilities and little co-operation from management. Moreover, there have been constant allegations that a shareholder that sues a major company often loses at the lower court level; it was suggested that this might stem from a combination of pressure by local authorities and sometimes corruption. A persistent shareholder with a strong case has an opportunity to receive a fair judgement on appeal. But pursuing a case through three court levels could take years. At the final stage, enforcing a judgement has been known to be problematic, because the same court that gave the original ruling is also responsible for execution. While a number of cases have been decided, there is no evidence yet as to whether the awards
for damages to shareholders have been effectuated. In order to improve the Supreme Arbitrazh Court’s influence over decisions at the lower courts, it could be useful to issue binding guidelines that give some interpretation to the law where it is vague. This will allow judges to pursue a more coherent approach.

29. Enforcing the Company Law remedies for illegal or abusive behaviour by directors or management of a company is also quite weak. It is unclear who has the right to file a derivative suit. Most importantly, the duties of the directors and management are ill defined. Establishing fiduciary duties for management with detailed prescriptions for personal liability could help improve judicial practice in this area. Introducing criminal liability in instances of commercial property abuse and other offences, as is the case in some OECD countries, could also be envisaged.

30. In some recent cases, the courts have made a worrying interpretation of the law’s main minority protection positions. It was decided that the court could uphold contested decisions in cases where the vote cast does not affect the results, if there is no material breach and if the decision does not cause damage to the shareholder. This sets a dangerous precedent for upholding legal requirements and might send the wrong signal to both the abusers and the abused as regards the rule of law.

31. Long-term improvement in the area of corporate governance will only occur if institutions are adequately developed. The Courts, especially the Arbitrazh Courts, need to become the focus of a great institution building effort as they are key in restoring investor confidence of the Russian market environment. This includes full publicity of their written opinions and decisions, more and better paid judges and clearer jurisdiction as regards commercial law cases. This jurisdiction is now shared with civil courts and is often confusing as well as counter-productive.

32. Changes in the legal framework last year have considerably improved the possibility of legal redress for shareholder violations. The 1999 Investor Protection Law is a step in the right direction as it stipulates that the FCSM can file lawsuits and initiate court proceedings on behalf of individual shareholders or the state when their rights have been violated. The Commission is assisted by self-regulatory organisations such as PARTAD and NAUFOR that can now investigate the violation of shareholder rights by registrars, depositaries or custodian and brokers, respectively. While Russian legislation does not specifically provide for class action suits, a joint complaint by shareholders is possible during appeals procedures and by filing a collective claim through the FCSM. The Commission has also successfully brought a number of cases to court and has won more than 80% of them. However, in comparison with its OECD equivalents, the FCSM still has relatively few weapons and a weak institutional capacity to enforce the laws. It is vital that the new leadership continues to strengthen its independent role as a regulator to improve shareholder rights and equitable treatment. The FCSM should be provided with adequate resources to fulfil this task.

Rules related to the integrity of the equity market

33. Insider trading and other rules related to the integrity of the market are another area of concern. Insider trading rules enhance the functioning of the market by providing equal information rights to all investors. Russian Securities Law prohibits insider trading but enforcement is problematic. This is not surprising, given the extreme difficulty of tracking down and producing evidence for such abuses. Nevertheless, it is important to send investors a signal that insider trading is being controlled.

34. Widespread insider trading in a transition environment like Russia exacerbates adverse selection. Due to the high discounts demanded by investors on the domestic capital market, good companies are forced to leave. The equity market’s role as a corporate finance tool and as a resource allocation mechanism remains negligible. In the absence of an efficient banking sector, this longer term impairment of equity markets might limit access to external finance for large Russian corporations.
35. What is more disappointing than the failure to enforce insider trading rules, is the little success until now of the market participants and their professional self-regulatory organisations in providing their own surveillance of the market’s integrity and in driving the effort for a more level playing field. They are the ones whose survival and prosperity depends on better corporate governance even in the short term. Recent changes in the legislation give them the opportunity to play a leading role in this respect and they are encouraged to make full use of it. In addition to signalling violations by issuers through the mass media, direct appeals, lobbying within the parliament and other administrative methods, investment intermediaries also need to be perceived as putting their own house in order.

36. Stock exchanges might also play a central role as they have the authority to exert pressure on companies, educate them on the rules and how to use them. It is in their interest to ensure a fair and open marketplace that will improve liquidity in Russia. A more transparent market would lead to better price performance and higher liquidity to the benefit of Exchanges. This would, however, need a further drive towards consolidation of Russian exchanges. Exchange authorities in Russia can protect the integrity of the market through more stringent listing requirements and tighter monitoring to better track price manipulation. They can also be more active in using sanctions, such as suspending trading and de-listing. Exchanges in some OECD countries have benefited from the introduction of a real time trading mechanism. In Russia, selling real time market information at a low cost could shorten time delays, broaden the monitoring capacity of the general public, and improve the chances of reporting violations. Imposing tougher civil liability for price manipulation can also be envisaged.

**Corporate strategy and incentives**

37. Shareholders are also encouraged to take a more pro-active approach in defending their rights. There is some concern that as market perceptions improve and stock prices rise in Russia, investors become less vocal about corporate governance abuses. In this respect, the creation of the Co-ordination Centre for Investor Protection in October 1999 is an important development; it signals the will of equity market players in Russia to put the corporate governance issue at the centre of private reform efforts. Shareholder associations in OECD countries have proven to be powerful tools for educating and empowering investors. In Russia, it is encouraging that private organisations such as the Centre now have more tools to support shareholders in their legal action against offenders.

38. Some large Russian companies have started to realise that dilution of minority stakes and other self-dealings are undermining the image of the Russian market, preventing its development and impairing their access to outside finance. In the Yukos case, shareholders used a range of available remedies to defend their rights collectively, through the NAUFOR programme of investor protection. This was the first time a large number of portfolio investors joined together to safeguard their rights. Ultimately, in order to restore its image, Yukos bought back shares from some of its minority shareholders at a fair price. Since then, Yukos is reportedly making an effort to improve shareholder relations. The Vyksa case, which involved major corporate changes without the consent of minority shareholders, demonstrates the potential impact of a consolidated shareholder action. Realising the importance of maintaining investor confidence, the company settled the differences with its shareholders out of court and agreed to buy-back shares at market price.

39. In addition, companies are starting to realise that the cash flows they generated in 1999, resulting largely from the low rouble and the competitiveness of their exports, are not sustainable and that outside financing will be essential to fulfil their investment needs. As large Russian companies are starting to consider ways to improve shareholder relations, this is an opportune time to introduce proper incentives for managers, to encourage them to better understand shareholder value. OECD countries use various methods, including tying managerial performance to share prices.
Foreign direct and portfolio investment in Russia is far below its potential. In OECD countries, foreign ownership has had a positive impact on how companies relate to their shareholders, improving minority shareholder rights and corporate governance practices, in general. While some investors may rush back to the Russian market with the improvement of the macroeconomic situation, the more patient (and much richer) large foreign institutional investors will need a clear reassurance that management or controlling shareholders will not expropriate their capital. In order to support their entry (or return) to some emerging markets including Russia, a number of rating agencies are currently setting up rating systems for corporate governance. Another important signal to facilitate and focus institutional involvement, would be a clear commitment by large Russian corporations that they are now ready to submit to internationally accepted norms in a verifiable way and thus turn the page on their past corporate governance abuses.