Foreword

To improve investor confidence and lower the cost of accessing capital for Russian companies, a key priority is to improve transparency of corporate ownership structures and to clarify the responsibility for disclosure of related party transactions.[1] Deals between a company and its major shareholders or others in a position to influence company decisions can play a legitimate role in business life, but they must be consistent with corporate objectives and be subject to checks and balances. There is always a risk that some owners may extract private benefits at the expense of other shareholders. Improving reporting and transparency of related party transactions is thus a critical aspect of protecting shareholder rights and enhancing public confidence in the Russian capital market.

Shareholders and potential investors need accurate and reliable information if they are to take well-considered investment decisions. Protection of investor rights and improved corporate governance requires that the controlling shareholders and control arrangements of publicly listed companies be disclosed. It also requires a mandatory disclosure regime that effectively regulates related party transactions, clarifying the responsibilities of board members and management for disclosing such transactions. The issues are closely linked: control by an owner can be beneficial in monitoring company performance but can also be used to pursue illicit transfers of wealth via related party transactions. To curb abuse, transparency both of ownership structures and the nature of transactions is essential.

This report by the Russian Corporate Governance Roundtable's Task Force on Related Party Transactions seeks to provide Russian policy-makers, enforcement authorities, private institutions and other stakeholders with analysis of the key issues, policy options and actions needed to address the problems highlighted above. The Report, focusing on Russian publicly traded companies, may also be useful to technical assistance agencies working on these issues. The Roundtable established the Task Force in 2004 as part of its efforts to

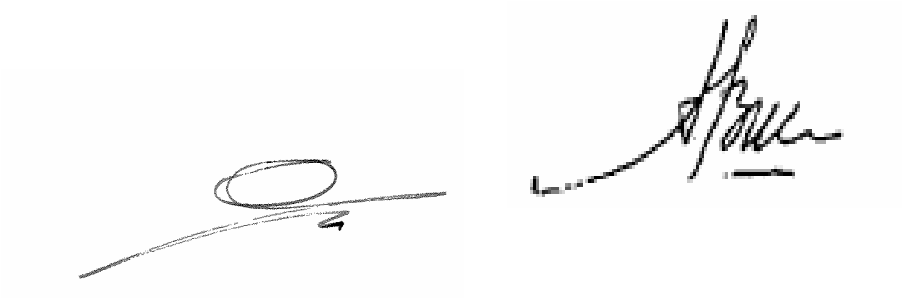
[1] Related party transactions are defined as transfers of resources or obligations between related parties, regardless of whether or not a market price is charged. Parties are considered related if one party has the ability to control or exercise significant influence over the other party in making financial and operating decisions for the company, for example, entities that control the company, board members, significant shareholders including their families, and key management personnel.

support implementation of the recommendations of the Russian White Paper on Corporate Governance.[2]

The Russian and OECD experts participating in the Task Force undertook extensive consultations in developing this report. It thus represents a shared vision for reform. Where consensus was reached, recommendations are offered. Elsewhere, analysis is provided of the qualities of different policy approaches and the trade-offs between them. The Russian Federal Service for the Financial Markets, the Ministry of Economic Development and Trade, and the Supreme Arbitrazh Court participated in the Task Force and in the preparation of this report.

[2] The Russian Corporate Governance Roundtable is organised by the OECD in co-operation with the World Bank Group and Russian partners. The work also enjoys financial support from the European Union under its Tacis programme and the OECD/World Bank Global Corporate Governance Forum.

We are grateful to members of the Task Force and thank them for their time and expertise. Their readiness to support the recommendations of this report and to encourage all members of the Russian Corporate Governance Roundtable to do the same is also welcome. The OECD will support this process through the ongoing work of the Roundtable.



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Executive summary

1. This Roundtable report makes suggestions on how to improve the transparency of related party transactions, which today is a central problem in Russian corporate governance. In particular, because related party transactions are a tool often used by controlling owners for their private benefit. Transparency through effective disclosure of related party transactions is of crucial importance to build trust in the Russian business sector and to protect important public interests.

2. In order to be effective, policies in this field must fit the country's legal traditions and also consider corporate ownership structures, balanced by the need to avoid over-prescription and intrusiveness with the desire to protect the public interest. In weighing the costs and benefits of different strategies to improve transparency of related party transactions, the Russian authorities must also take into account the particular policy aims and administrative responsibilities of the institutions charged with the difficult task of accomplishing these goals, and the quality of the corporate law framework and enforcement bodies for dealing with these conflicts.

3. On this basis, the Roundtable Task Force makes eleven recommendations:

1. *A broader definition of what constitutes an 'interested party' is required. The new definition should emphasise the ability to control the terms of the transaction and be consistent with IFRS.*

2. *The legal definitions covering 'interested parties' and 'affiliated parties' should be harmonised to avoid confusion and facilitate enforcement. A legal definition of an 'affiliated party' based on the concept of control should be introduced in the Joint Stock Company Law.*

3. *If 'interested parties' and 'affiliated parties' of related party transactions fail to notify the company, they should be subject to administrative liability.*

4. *The Federal Service for Financial Markets should have sufficient legal power with respect to supervision, investigation, sanctioning and enforcement of disclosure obligations on related party transactions. Administrative and civil sanctions should be sufficiently high to ensure deterrence.*

5. *Whatever the means chosen to challenge unapproved or inappropriately approved related party transactions, the Russian government needs to ensure that the transaction costs are not too high for injured parties to enforce their claims.*

6. *The quality of company board members should be improved to strengthen enforcement of the approval process of related party transactions. Internal company documentation should make sure that all board members are fully aware of their role and responsibilities in terms of reporting and approval of related party transactions.*

7. *Board members and managers should demand notification of transactions by the interested party of the transaction, and disclosure and approval procedures of related party transactions would be improved.*

8. *Russia should consider reducing the threshold of related party transactions for which shareholder approval would be required.*

9. *Russia should adopt measures similar to those of IOSCO and the EU to enhance disclosure of major shareholdings, which would lead to better market transparency and assist regulators and enforcement officials to curb illegal market activities. Also, it would be important for the company either to disclose to the market directly or allow the FSFM to do so.*

10. *The threshold for disclosing shareholdings should be reduced to around 5-10% in Russia.*

11. *Legislation/regulation should introduce administrative liability for failure to disclose major shareholdings. This would support enforcement and foster public confidence in the Russian capital market.*

IMPROVING TRANSPARENCY OF RELATED PARTY TRANSACTIONS IN RUSSIA

Why care about related party transactions?

4. There is widespread agreement about the important and legitimate role that related party transactions can play in everyday business life. Such transactions are authorized in many jurisdictions to permit flexibility and to make room for private contractual arrangements and entrepreneurship that are consistent with corporate objectives, and are subject to appropriate checks and balances. In some of these cases, the company's financial situation might preclude it from negotiating arm's length[3] arrangements with third parties: e.g. a loan guarantee by a parent company or controlling shareholder.

5. But related party transactions also raise important concerns. A key problem with related party transactions is that they can be unduly influenced by the relationship between the two sides of a transaction and not undertaken according to market prices. For both controlling shareholders and insiders such as managers, related party transactions can be the mechanism for extracting private benefits at the cost of other shareholders. The limited ability of investors to protect themselves against wrongdoings by insiders and the high cost of regulating such transactions has influenced regulators' strategies around the world to deal with related party transactions.

6. Furthermore, the nature of the regulatory challenge varies: in companies with controlling shareholders and with corporate groups, the transactions and the measures needed to deal with them will differ from those concerning, for example companies where ownership is dispersed and where the board and management are effectively entrenched. In each case, however, trade-offs must

[3] Arm's length refers to the bargaining position of two parties that are unrelated to one another and whose mutual dealings are influenced only by the independent interest of each.

be considered, because burdensome and overly restrictive rules could impede entrepreneurship, raise company costs and ultimately lower the value of the firm. This is particularly important in Russia where there is also a need to create confidence in the stability of the rules set by the state and guarantees that ownership rights will be preserved.

1. Amending and harmonising the legal definitions of 'interested parties' and 'affiliated parties'

7. The nature of a related party transaction and of related parties is best highlighted by general principles rather than listing categories of transactions, people and entities. According to IAS 24 of the International Financial Reporting Standards (IFRS), parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions for the company. Related party transactions are defined as a transfer of resources or obligations between related parties, regardless of whether or not a market price is charged. The OECD Principles on Corporate Governance take a similar approach and state that related parties can include entities that control the company (or are under common control), board members, significant shareholders including members of their families and key management personnel. Transactions involving major shareholders or their close family either directly or indirectly are potentially the most difficult types of transactions to identify.

8. In many jurisdictions, regulators have not established a definition of related parties but rely instead on the principles-based approach. While there is no simple formula to identify a related party that is required to disclose an interest to the board and auditors, experience underlines the importance of drafting legislation that carefully specifies the list of all parties involved. This means that the Russian government can draw on a variety of strategies, employed respectively by EU governments, the US and other OECD countries, to enhance its ability to write a law that improves the transparency of dealings between companies and affiliates in a transaction.

9. Given that conditions vary across jurisdictions, lawmakers should not expect to be able to transplant approaches directly from other countries to Russia, but must take into account national conditions when specifying the terms 'interested parties' or 'affiliated parties'. To undertake credible institutional reform, the Russian authorities must also weigh the costs and benefits of alternative strategies, taking into account the particular policy aims and administrative responsibilities of the institutions charged with the difficult task of accomplishing these goals, and the quality of the corporate law framework and enforcement bodies for dealing with these conflicts.

10. The Task Force discussion on the policy options for tackling related party transactions in Russia focused on the trade-offs between a formal legal approach to definitions and a more contextual approach relying on a high degree of judgment. On the one hand, in Russia the list of interested parties and related transactions must be rather strictly defined in the law. On the other hand, this alone would not necessarily effectively prevent all abuses of related party transactions, as some transactions might not fall under the formal legal criteria – and the more so with time as parties learn how to circumvent the law. As a result of this formal legal approach, some persons (e.g. deputy general managers, chief accountants, heads of affiliates and branches) are not presently included among interested parties, and transactions in their favour do not require special approval and cannot be contested.

11. Despite the shortcomings of a formal legal approach to the definition of interested parties and related party transactions, the Task Force reached a consensus that at the current stage of the Russian judicial system's development it is still the preferred option. Taking a more contextual approach would give wide discretion to courts[4], who often lack the necessary experience with these cases, with the associated risk of delayed and inconsistent judgments.

1.1. 'Interested party'

12. Given the narrow definition under Russian law, a broader definition of what constitutes an 'interested party' is required emphasizing the ability to control the terms of the transaction and be consistent with IFRS.

13. The term 'related party' does not appear in Russian law, except in Russian audit regulations. Russian company and securities law as well as securities regulation refer to 'interested party' and 'affiliated party'. Under the Russian Joint Stock Company (JSC) Law, which is quite specific and less based on general principles, a conflicted transaction is marked by the presence of a direct or indirect interest in the transaction by a list of parties[5] who may influence the

[4] Determining whether a party is conflicted or independent usually requires the judge to investigate the context – this is the U.S. approach and does require a trained judiciary – and the willingness of parties to bring cases to court, which depends, in turn, on the quality of courts. The impetus to undertake statutory reform to improve transparency of related party transactions also extends to the reform of courts to ensure that they have sufficient expertise and resources to accomplish this aim.

[5] The list includes: (1) members of the board of directors; (2) a person who performs the function of the sole executive body in the company; (3) members of the management board; (4) parties authorized to issue mandatory instructions to the company; and (5) a

terms and conditions of the company's transaction. Such parties include a company shareholder who owns, individually or jointly with 'affiliated parties', 20% of the company's voting shares. According to the JSC law, they are considered ' interested' in a transaction if they or their spouses, parents, children, brothers and sisters, parents in law, children in law and (or) their affiliated parties are the counterparties, beneficiaries, agents or representatives in this transaction; acting individually or in concert owns 20 % or more of shares in a legal entity that is a counterparty, beneficiary, agent or representative in this transaction; are managers in the legal entity being the counterparty, beneficiary, agent or representative in this transaction, or in the managing company of such a legal entity; and in other cases as stipulated in the company charter.

14. When considering closing gaps in and harmonising of Russian legislation, it would be important to introduce the notion of 'control' and not only ownership. This would provide an opportunity to identify indirect owners as beneficiaries in a transaction. A company's chief accountant and other key members of the management team (such as deputy general managers and heads of affiliates and branches) are also in a position to potentially control the terms of a transaction and should be required to submit the same information as the parties already specified. This proposal would widen the scope of parties that come within the definition of 'interested parties' and should generate more information about related party transactions. This measure is likely to have positive effects on deterrence and ease discovery by shareholders which should, courts permitting, be expected to lead to improved enforcement in Russia.

1.2. 'Affiliated party'

15. ***The legal definitions covering 'interested parties' and 'affiliated parties' should be harmonised to avoid confusion and facilitate enforcement. A legal definition based on the concept of control should be introduced in the Joint Stock Company Law of an 'affiliated party'; it should include measures enabling a company and its shareholders to exercise control over related party transactions executed in breach of the established procedure.***

16. Under Russian law, the definition of 'interested parties' is closely related to the notion of 'affiliated parties'. This has led to confusion, which has had a negative impact on the effective regulation of related party transactions. The Roundtable discussions and Task Force consultations highlighted that the notion

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company shareholder who owns individually or jointly with affiliated parties 20% of the company's voting shares.

of 'affiliated parties' as defined in the Competition Law relates primarily to legal entities and to individuals who are registered as individual entrepreneurs. This causes difficulties when applied to individual shareholders with significant stakes or family holdings registered to several individuals, none of whom may be registered as individual entrepreneurs.

17. 'Affiliated parties' are defined in the Russian Federal Law *On Competition and Restriction of Monopolistic Activities on Goods Markets* (or the Competition Law) as physical and legal persons capable of influencing the business of legal and/or natural person engaged in entrepreneurial activities.[6] Physical persons not engaged in entrepreneurial activities are not covered by the Competition Law. This is problematic from a company law perspective since it is physical persons who are not individual entrepreneurs that make up a considerable number of shareholders in many companies. And yet when courts apply the rules of the JSC Law in interpreting the meaning of 'affiliated parties', they proceed from the need to be governed by the definition contained in the Competition Law[7]. As a result, a shareholder who is not an individual entrepreneur but holds 19 % of shares, while his/her spouse or other relative (also not engaged in entrepreneurial activity) also holds 19% of the same

[6] 'Affiliated parties of a physical person' engaged in entrepreneurial activities are :parties belonging to the group of parties to which the given physical person belongs to; a legal person where the given physical person has the right to dispose of over 20 per cent of the total number of votes by voting shares or the contributions or shares of this physical person forming the charter capital or joint stock; 'Affiliated parties of a legal person' are: (1) a member of its Board of Directors (Supervisory Board) or another collegiate management body, (2) a member of its collegiate executive body, and also a person having the powers of its sole executive body; (3) parties belonging to a group of parties to which the given legal person belongs; (4) parties who have the right to dispose of over 20 per cent of the total number of votes by voting shares or the contributions or shares of this legal person forming the charter capital or joint stock; (5) a legal person in which the given legal person has the right to dispose of over 20 per cent of the total number of votes accounted for by the voting shares or the shares of this legal entity forming charter or joint stock capital; (6) if a legal person is involved in a financial-industrial group, their affiliated parties will also include members of the Boards of Directors (Supervisory Boards) or other collegiate management bodies, collegiate executive bodies of the participants in the financial-industrial group and also parties having the powers of the sole executive bodies of the participants in the given financial-industrial group.

[7] The Federal Arbitration Court of the Moscow District in the Resolution of 21 March 2002 # КГ-А40/2619-01 stated that as it has been indicated by the Court, the parties indicated by the claimant are not affiliated ones according to Art. 4 of the RSFSR Law *On Competition and Restriction of Monopolist Activities in Commodity Markets*

company's shares, under Russian law will not be considered an affiliated party, and so will not trigger the application of rules on related party transactions.

18. It is important for the JSC Law to use legal terms and categories that are appropriately defined to meet the goals of company law. The term 'affiliated party' is rarely, if ever, used in the practical application of the Competition Law, and its exclusion from a new draft competition law currently under discussion is extremely likely. Thus, an appropriate amendment could insert the term in the JSC Law and give it a definition appropriate for that use, if preservation of the term were desired. In the alternative, another term could be chosen for that purpose.

2. Policies to control related party transactions

19. Company law in many countries allows related party transactions but also includes a variety of techniques and measures to control the related danger of abuse. Common law and civil law countries have similar legal strategies to control related party transactions: mandatory disclosure, board approval, the specification of fiduciary duties for the board, and shareholder approval[8]. These provisions address the agency problem of shareholders by providing them with information and means of legal redress.

2.1. Disclosing related party transactions

20. Mandatory disclosure is one of the major pillars of effective regulation of transactions that potentially conflict with the interests of the company and its shareholders. In many countries, public disclosure by the company is stringent and should lead to transparency of related party transactions. For example, in US listed companies, registered investment companies and other companies subject to the Securities and Exchange Commission reporting rules are required not only to publicly disclose all major transactions but also certain relationships and material transactions between the company and its managers and/or their families and their enterprises[9]. From 2005, EU companies listed on EU

[8] The key elements of fiduciary duty of the board are defined in the OECD Principles of Corporate Governance as the duty of care and the duty of loyalty. The duty of care requires board members to act on a fully informed basis, in good faith, with due diligence and care. The duty of loyalty is key especially within the structure of a group of companies and emphasises that such duty of loyalty for a board member relates to the company and its shareholders as a whole and not to the controlling company of the group.

[9] To give an indication of what is required, around a third of US listed companies report related party transactions. The figure for Europe, which is more difficult to measure, is

regulated markets and reporting consolidated accounts will be required to disclose transactions according to IFRS. For Russian companies adopting IFRS for consolidated accounts, standards will tighten considerably. For example, under IAS 24 the existence of related parties needs to be reported even where no transactions have occurred.

21. ***If 'interested parties' and 'affiliated parties' of related party transactions fail to notify the company, they should be subject to administrative liability.***

22. In Russia, the disclosure of concluded related party transactions is governed by the Federal Law on Securities Market (Securities Market Law). According to the Federal Commission on the Securities Market Regulations (the former securities regulator now replaced by the FSFM), the requirement to disclose related party transactions applies only to open joint stock companies that have registered their prospectus. Listed companies are required to disclose this information in their prospectus and quarterly statements. Interested parties are required to make a report to the board of directors[10], audit commission and auditors. Similar requirements are imposed on affiliated parties. However, there is no liability nor sanctions for non-notification by related parties.

2.1.1. Russia's implementation of IFRS will have an important positive impact on disclosure

23. There are a variety of techniques to help identify the existence of related party transactions and facilitate their disclosure. Accountants, auditors, board members and regulators are encouraged to pay specific attention to indicators, such as : the existence of interest-free borrowing, asset sales that diverge from the appraisal value determined by an independent party, in-kind transactions and loans without scheduled terms when reporting the financial position of a company.

24. Related party transactions involving day-to-day commercial transactions are usually more difficult to detect, although in the raw material sector, for example, market prices allow a relatively easy cross-check. Boards increasingly have the tools to monitor and control these relationships through extended

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around 10 per cent but this certainly reflects weak reporting criteria in many countries up till now. The SEC rules require disclosure when specified management are involved, that includes any director, the CEO and the next four highest paid officers, more than 5% beneficial owners and parties related to or controlled by such parties.

[10] In this document, the term 'board of directors' and 'board members' refers to the 'supervisory board'.

accounting and audit procedures and the collection of business related information from financial intermediaries. Overall, the growing trend for governments to improve accounting principles and scope of financial reporting has enhanced the ability of board members and regulators to identify and investigate undisclosed related party transactions.

25. A threshold standard on the value of a transaction may need to be defined for improving disclosure of related party transactions with 'affiliated parties'. This may be immaterial to the company's financial statements as required by IFRS but sufficient to compromise the independence and integrity of individual persons.[11] Otherwise, disclosure of large related party transactions that are in fact material to the individuals (but not to the company) benefiting from the transactions may be omitted.

26. Like some other countries, Russia has made several attempts to introduce IFRS. Each has met with a varying degree of success; none has succeeded fully. At the time of writing, the conditions for IFRS reform are encouraging. The Russian Corporate Governance Roundtable endorsed 25-recommendations to facilitate the transition to IFRS in Russia. The recommendations have been incorporated into the Russian Ministry of Finance's own reform strategy and a bill to make IFRS statutory for some companies is being considered by the Russian Duma. Reporting according to IFRS, including IAS 24 on related party transactions should have a positive impact on disclosure in this area, so long as accountants and auditors strictly observe the new standards.

2.1.2. The policy trade-offs for mandatory disclosure of related party transactions

27. Not all companies will move to IFRS, and for those that do not, mandatory disclosure is generally recommended. Mandatory disclosure has a number of distinct positive characteristics that ensure a high degree of accountability and quality of information to investors. To the extent that disclosure has capital market implications, such as lowering the share price of companies involved in suspect transactions and material misstatement of financial data, this technique delivers significant economic benefits as well as regulatory outcomes that adequately consider costs/benefits. Moreover, provisions that place substantive restrictions on suspect transactions and require an informed response by board members for ensuring management's disclosure of conflicted transactions

[11] In the U.S. for example, a $60,000 threshold for interest in a related party transaction is used even though the company involved may be a multi-billion dollar enterprise.

derive from the mandatory disclosure regime. Mandatory disclosure can also be used to promote a more efficient regulatory system. Legitimate related party transactions, on the whole, are exempt from costly constraints, which facilitate the key goal of promoting an effective, low cost regulatory landscape that generates significant economic benefits.

28. However, mandated disclosure of related party transactions may generate substantial burdens for companies. Most countries still face the challenge of creating a centralized system of reporting. Naturally, the cost of disclosure will be higher in countries where the reporting processes are at an earlier stage of development. This is the case in Russia, where the penalties imposed for non-compliance are much lower than the costs of disclosure. Empirical evidence suggests that in countries where securities regulations and the system of reporting have been improved, these reforms have substantially benefited issuer firms and investors overall.

29. The benefit of disclosure, however, does not affect all firms equally. While the cost of disclosure for most EU publicly listed firms is quite low, the ability of small cap listed firms to absorb these costs is a challenging task, driving some companies to convert to a less restrictive legal form. The choice between general disclosure rules—as opposed to tailored rules that are applicable to companies with a particular size and capital structure, represents a trade-off between information and enforcement in a particular area of the economy. When considering the long term impact of reporting requirements, it is a fundamental concern to design a regulatory policy that meets the needs of a country's diverse type of firms.

2.1.3. Effective enforcement is crucial

30. ***The Federal Service for Financial Markets should have sufficient legal power with respect to supervision, investigation, sanctioning and enforcement of disclosure obligations on related party transactions. Administrative and civil sanctions should be sufficiently high to ensure deterrence.***

31. A review of EU and US regulation suggests that effective enforcement tools are needed to ensure the identification and reporting of related party transactions. Although the importance of clear, open and effective disclosure is well established, compelling parties to disclose certain relationships and related party transactions in public filings and financial statements also involves trade-offs.

32. Securities regulators in some other jurisdictions are given discretion to impose administrative measures, such as fines and other more severe sanctions,

to ensure compliance. The importance of enforcement mechanisms to meet regulatory goals is confirmed by recent cross-country studies that show how the quality and effectiveness of disclosure regulation depends on the willingness of regulators to establish procedures and undertake enforcement actions against parties that are in breach of the law. The FSFM should focus its resources on monitoring compliance with disclosure requirements on related party transactions and also be able to impose fines that are high enough to deter non-compliance. However, shareholders should still be viewed as the primary initiator of complaints and the regulator should promote and facilitate shareholder activism, when necessary.

33. In addition it is also important that companies comply with their own internal reporting systems and ethical codes covering related party transactions. If managers do not declare such transactions, they should be liable to be dismissed and compensation to the company should be considered.

2.2 Approving related party transactions

2.2.1.Board approval

34. Most jurisdictions rely on board approval to screen related party transactions and evaluate whether the transaction is at arms length (i.e. on normal commercial terms) or whether it is detrimental to the company. This mechanism also promotes greater transparency. Authorization for most related party transactions in other jurisdictions can usually only be given by non-interested board members. Even though lawmakers in common law countries do not typically require mandatory board approval, they nevertheless encourage interested managers or controlling shareholders to obtain approval of conflicted transactions.

35. It has long been appreciated that the most appropriate remedy for abuse of the approval process is either the threat of nullification[12] or requiring compensation for damages. The threat of nullification serves to protect investors by encouraging ex ante disclosure of conflicted transactions to shareholders and can increase their ability to take action against these transactions through, for example, an injunction. The strength of the ex post damages remedy is that it directly benefits the party that has suffered damage (i.e. shareholders and other affected parties). There is considerable variation across jurisdictions in their choice of damages remedies for unapproved related party transactions.

[12] Russian law provides for "voiding transactions" rather than "nullification".

36. According to the JSC Law, when affiliated parties are identified in a transaction, the board of directors is to hold a vote without the participation of the interested parties. In companies with more than 1,000 shareholders, only board members without an interest may vote. But this does not imply that they are truly independent and able to exercise objective judgement. As with most major jurisdictions, the remedy under the JSC Law for a related party transaction completed without non-interested board approval is either to void the transaction or to compensate the company for the resulting loss. However, enforcement by the courts has been poor. Courts are inclined to reject shareholders' claims because the shareholders cannot prove that the resulting damages were directly caused by the related party transaction.

37. In practice, in Russia most related party transaction cases involve plaintiffs seeking to reverse transactions. When choosing between the threat of nullification and damages, governments need to balance the potential benefits in order to move toward an optimal policy. On the one hand, nullification can be costly to both the conflicted internal party who failed to obtain *bona fide* prior approval and to third parties who perhaps were involved in the transaction on a *bona fide* basis. In contrast, other countries rely on the ex post damages remedy depending on the willingness of shareholders to undergo reasonable costs to bring actions and the quality of the courts to enforce the law.

38. ***Whatever the means chosen to challenge unapproved or inappropriately approved related party transactions, the Russian government needs to ensure that the transaction costs are not too high for injured parties to enforce their claims.***

39. When enforcement is weak, improving the procedural rules that make it easier for shareholders and other parties to the transaction to bring judicial action against the board will promise significant benefits by ensuring more potential liability against board members.

40. ***The quality of company board members should be improved to strengthen enforcement of the approval procedures of related party transactions. Internal company documentation should make sure that all board members are fully aware of their role and responsibilities in terms of reporting and approval of related party transactions.***

41. This can be done through changes in the Russian Corporate Governance Code that can foster improvements in the board oversight and approval process of conflicted transactions. But as elsewhere, improving corporate governance codes alone is not sufficient to address the problem of conflicted transactions.

42. The Task Force recognized the importance of helping boards to cope with these complex judgments by improving the competence of the board members that serve on boards. Private initiatives, such as those introduced by the Russian Institute of Directors and the Independent Directors Association, can do much to improve the skills and effectiveness of board members. International experience highlights also the importance of introducing effective firm-level standards to monitor managerial and controlling shareholder opportunism.

2.2.2. Enforcing fiduciary duties

43. Fiduciary duties are important legal rules that serve to underpin the role of the board. In many countries, the duty of loyalty to the company operates to control managerial conflicts of interest[13] and limits the potential for opportunism by requiring the screening of related party transactions.

44. ***Board members and managers should demand notification of transactions by the interested party of the transaction, and disclosure and approval procedures of related party transactions would be improved***.

45. Reinforcing fiduciary responsibilities for board members and managers in Russia would also provide a basis for shareholders to seek remedies and serve to limit the incidence of illicit related party transactions. The duty of loyalty is the main legal doctrine involved in regulating the disputes that arise between management, board members and shareholders whose rights are abused. Moreover, it can provide a standard for boards of directors when approving related party transactions. The duty of loyalty can also underpin market mechanisms, such as the market for corporate control, to limit abusive transactions. While this is not realistic for Russia in the short term, the market for corporate control should be developed and is key for future developments. The White Paper on Corporate Governance in Russia recommends that board members should be provided with practical guidance on the meaning of the legal requirements to act "reasonably and in good faith", in order to assist in determining what can be considered as "sound business judgment". The Russian Corporate Governance Code has introduced this guidance but there has been little experience with its application.

46. In devising new policies on improving enforcement actions, lawmakers must bear in mind the costs and benefits of a change in the law to facilitate shareholder action. Opportunities for Russian parties to bring enforcement

[13] This is the most common form of related party transaction in companies with widely held shares.

actions are currently weak. New evidence confirms the importance of shareholder action when shareholders are given tools to enforce fiduciary duties against directors. Recent surveys of Germany, Korea, and the United States show that changes in shareholder protection laws are consistent with higher share valuations of company stock. Improving the use of courts by companies and shareholders to solve disputes reinforces better protection of shareholder rights.

2.2.3. Shareholder approval

47. ***Russia should consider reducing the threshold of related party transactions for which shareholder approval would be required.***

48. According to the JSC Law, if the number of non-interested or independent board members is less than a majority or for joint stock companies with more than 1,000 shareholders if there are no non-interested independent board members, the decision on a related party transaction is to be made at a shareholder meeting. Decisions on large related party transactions concerning at least 2% of the company's assets (which can also involve large transactions in the normal course of business) or additional issues of more than 2% of the company's shares must be made at shareholder meetings with a simple majority vote of the non-related shareholders. This approach only works where the related party has fully disclosed their voting rights and abstains from voting. Empirical evidence suggests that this has not occurred in Russia.

49. Shareholder voting provides an additional level of security and higher transparency when reviewing conflicted transactions of managers although many jurisdictions have removed the requirement of shareholder approval for traditional self-dealing transactions. Indeed the OECD Principles call for more shareholder input in the case of extraordinary transactions (conflicted or not) which can involve the transfer of major assets. Extraordinary transactions such as the sale of the company or substantially all of its assets, usually requires shareholder approval and might be challenged if conflicted parties also vote. Weak decision-making and information-gathering abilities of board members may make it necessary to have shareholders screen these transactions. However, while shareholders have strong incentives to maintain the value of the firm's assets, the costs of informing widely dispersed shareholders on these transactions may often offset the benefits.

50. Shareholders, like board members, are prone to misjudgement due to asymmetric information problems and may be less well informed than board members in making these judgments. There are very few jurisdictions that take the precaution to require shareholder approval of conflicted transactions. France

is the major EU nation that specifies shareholder approval where the transaction falls outside the ordinary course of business. This mechanism is neither perfect nor costless, but may work well in some circumstances. In other countries such as the UK, shareholders can convene a special meeting to vote on transactions such as the sale of all or substantially all of the business and of course if they do not support other related party transactions they can always attempt to change the whole board.

3. Implications for disclosure of beneficial ownership

51. Tighter disclosure standards by companies and improved enforcement and approval mechanisms, if implemented as recommended, would go a long way to dealing with a key issue in Russia: the abuse of power by those in a position to control companies. The responsibility is firmly with the company to disclose and to control what it knows to be transactions not on market terms. The beneficiary is also required to report, but apparent beneficiaries, including other companies (maybe registered overseas) or a trustee may not be the real ultimate beneficiaries.

52. Related party transactions, and a number of other issues concerning corporate governance, revolve around the question of who actually benefits from transactions and from control. However, the issues are complex involving also questions of confidence in ownership rights.

53. From a corporate governance perspective, the disclosure of beneficial ownership is important in order for investors to have clarity about the capital and control structure of the company. It is useful although not absolutely necessary for the transparency and control of related party transactions. The *OECD Principles of Corporate Governance* provide some guidance on disclosure of major ultimate share ownership and voting rights that together constitute beneficial ownership. Countries often require disclosure of ownership data once certain control thresholds are passed. Such disclosure might include information on major shareholders and others that, directly or indirectly, control or may control the company through special voting rights, shareholder agreements, the ownership of controlling or large blocks of shares, significant cross shareholding relationships, cross guarantees and agreements or arrangements about the appointment of directors. Understanding control thus involves more than just knowing who the formal registered owners of blocks of shares are. Particularly for enforcement purposes which also cover takeover and competition laws, and to identify potential conflicts of interest and insider trading, information about recorded ownership may thus have to be complemented with information about the beneficial owner. In cases where major shareholdings are held through intermediaries or other arrangements

including trustees, information about the beneficial owner should therefore be obtainable at least by regulatory and enforcement agencies and/or through the judicial process[14]. But OECD countries vary greatly, with some requiring upfront disclosure of beneficial owners when control is involved, while others rely on the enforcement/investigation route.

54. Policy about the disclosure of beneficial owners when control is involved raises important questions about potential benefits and costs. On the one hand, disclosure of beneficial ownership provides an additional mechanism to increase transparency and control of abusive related party transactions. It is also particularly important when it comes to shareholder approval of, in particular, transactions such as the sale of a company or substantially all of its assets, as well as takeovers. In these cases, the concept of a market price is more difficult to determine. On the other hand, a policy that mandates a very specific disclosure of share ownership and control mechanisms can lead to increased costs for controlling shareholders, increased personal risk to individuals and their families and as a consequence, appreciably lower levels of regulatory compliance. Whatever the means chosen to enhance the protection of shareholders' rights, experience shows that governments should devise a policy that suits their specific needs, legal traditions and the existing ownership structure, balanced by the need to avoid over-prescription and intrusiveness with the desire to protect public interest. The credibility of regulatory institutions and the courts will also be an important determinant of policy choice.

3.1 The situation in Russia: an emphasis on disclosure by companies

55. ***Russia should adopt measures similar to those of IOSCO and the EU to enhance disclosure of major shareholdings, which would lead to better market transparency and assist regulators and enforcement officials to curb illegal market activities. Also, it would be important for the company either to disclose to the market directly or allow the FSFM to do so.***

56. Under the Russian Securities Market Law, disclosure of registered ownership is required for the following transactions: (1) the acquisition of 20% of securities other than non-convertible bonds; and (2) the acquisition of any

[14] The OECD Template *Options for Obtaining Beneficial Ownership and Control Information* can serve as a useful self-assessment tool. A self-assessment tool for Russia based on the Template was prepared by Alexey Timofeev, Legal Adviser, Center for Capital Market Development Foundation, Russia. www.oecd.org

additional tranche of 5% of securities above 20% as well as the sale of tranches of 5% if the remaining stake is higher than 20%. The owner must notify the Federal Service for Financial Market. In addition, under the Russian Law companies are obliged to disclose information on shareholdings at or above the threshold of 5% of the issuer's capital in their prospectus and quarterly reports (and to make it available on their firm's website). However, companies are not required to disclose shareholders beyond nominees, which are usually the registered holder. The requirements for joint stock companies are stricter. Under FCSM Regulation, companies should disclose information on a holder at or above the 5% of common shares immediately after they know about an acquisition. In any case, behind nominees might be a trustee and/or a limited liability company, both of which can effectively conceal beneficial owners. This has significant implications for effective enforcement of corporate governance and potentially for the full transparency of related party transactions.

57. The IOSCO non-financial disclosure standards, now used in the EU Prospectus Directive, requires disclosure in a prospectus or listing particulars document of principal beneficial owners known to the company. EU Consolidated Admission and Reporting Directive disclosure requirements mandate that companies provide detailed information on: (1) the structure of their capital; (2) any restrictions on transfer of securities; (3) significant direct and indirect holdings of securities; (4) the holders of any securities with special control rights; (5) the system of control of any employee share scheme in which the employees do not exercise control; (6) any restrictions on voting rights; (7) agreements between shareholders that are known; (8) the rules relating to appointment and replacement of board of directors; (9) the powers of the board, particularly with regard to share buybacks; and (10) significant shareholder agreements with other companies to which the company is a party.[15]

58. ***The threshold for disclosing shareholdings should be reduced to around 5-10%[16] in Russia.***

59. The current 20% threshold for disclosing ownership is too high when set against the criteria of the ability to control the terms of a transaction, as required

[15] The EU follows the International Organisation of Securities Commissions (IOSCO) "International Disclosure Standards for Cross-Boarder offerings and Initial Listings by Foreign Issuers" issued in 1998. Although intended as initial statements, the standard provide as useful definition on non-financial aspects of disclosing related party transactions.

[16] This threshold is used by most OECD jurisdictions.

under IFRS. Therefore the threshold needs to be set at a more realistic level in order to effectively identify control.

3.2. Disclosure by owners not known to the company

60. Principle 15 of the IOSCO Objectives and Principles of Securities Regulation, states that there should also be an obligation of disclosure by the beneficial owner of more than a specified threshold (5% or 10%). As a member of IOSCO, if Russia does not require this, it would be deemed as not implementing the IOSCO Methodology for measuring implementation of Principle 15. There is, however, no legal definition of 'beneficial owner' in Russian law. The concept is very often confused with the definition of 'trustee' used in the common law countries, a concept absent in Russian law. The Russian law defines a beneficiary as a person to whom certain funds, incomes, fulfillment of obligations are due. However, this does not allow for the disclosure of a firm's capital structure. To avoid this confusion it would be important to clearly define 'beneficial owner' but it is probably necessary to rely on other definitions that already exist in the Russian law, such as ' affiliated parties' . Then the beneficial owner would be defined as a person or entity that is ultimately entitled to receive dividends and voting rights associated with the shares of a company. However, before undertaking such a difficult exercise, the whole strategy would need to be considered. Consistent with the recommendations in the first part of this paper, attention should be devoted to the disclosure of related party transactions. This means that disclosure of 'beneficial owner' should focus for the time-being on registered shareholders.

3.3. Enforcement considerations

61. ***Legislation/regulation should introduce administrative liability for failure to disclose major shareholdings. This would support enforcement and foster public confidence in the Russian capital market.***

62. In Russia, the administrative liability of shareholders for misleading or false disclosure or the failure to report has not been effectively instituted. Criminal liability[17] for malicious non-disclosure to the regulator is hard to

[17] In accordance with Article 185.1 of the Criminal Code on 'Persistent evasion from provision to the investor or controlling body of the information specified by the Russian Federation legislation on securities):"Persistent evasion from provision of information on the issuer, its financial and business activities and securities, transactions and other operations with securities, committed by a person being obliged to provide the said information to the investor or controlling body, or provision of the deliberately incomplete or false information, if these deeds caused major damages to citizens,

invoke for lack of clarity on its applicability to specific cases and also usually involves high standards of proof.

63. It is somewhat difficult to assess the relative costs and benefits of this liability option without reference to different approaches that have been taken across OECD countries in recent years. Most countries have developed administrative procedures to deal with non-compliance with statutory notification requirements for significant shareholdings. Although there are a wide range of legal strategies to encourage a robust system for disclosure of information, many countries tend to focus their efforts on providing administrative penalties in case of non-compliance. There are, nevertheless, important variations in the OECD countries reviewed regarding penalties imposed for non-compliance. Civil penalties play a greater role in many jurisdictions, whereas the suspension of the investor's voting rights and dividends appears to be favoured in France. Australia and Canada take a middle road, favouring an investigation regime with strong powers of discovery when the securities regulator believes that beneficial ownership of significant holdings of shares have been concealed[18].

64. France has one of the most stringent enforcement regimes but it is in part driven by the aversion to hostile or creeping takeovers. French securities law requires that failure to comply with notification requirements results automatically in the suspension of the investor's voting rights in excess of the relevant threshold, effective for a two year period following the rectification of the notification. In addition, the company, its shareholders or the French securities regulator "Commission des operations de la bourse" may petition a French commercial court to suspend all or part of the non-complying investor's voting rights for a period of up to five years. In determining penalties, the court may subject the investor to a criminal fine as laid out in Article L247-2 of the French Code of Commerce. By contrast, other jurisdictions are less insistent on stringent administrative and criminal penalties and rely exclusively on civil penalties for non-compliance of notification requirements. New Zealand securities law requires that the investor holding a substantial number of shares give notice to the Securities Commission when statutory thresholds have been reached. Failure to comply with the notification procedures will trigger a civil

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organizations or the State, are sanctioned with a fine in the amount up to RUR 300,000 or in the amount of salary or other income of the convicted person for the period up to two years, or compulsory works for the term from 180 to 240 hours, or corrective works for the term from 1 to 2 years".

[18] It should be noted that in these countries, shareholder agreements and other mechanisms of control are for many reasons rare, so the focus is on shares actually owned or under the control of a beneficial owner.

penalty as set forth in the Securities Markets Act. Civil remedies are favoured because they appear to provide an effective instrument to secure compliance.

65. The difference in enforcement techniques appears to be related to the ownership structure. In countries that have substantial controlling shareholders or cross-ownership ties, it is not surprising that these jurisdictions attempt to limit the possibility of abuse by strictly enforcing the statutory notification requirements for crossing ownership thresholds. It is France, with a high percentage of companies that exhibit substantial cross-holding relationships and block-holding positions in large publicly listed companies, which favours a notification regime that has real enforcement powers. On the other hand, related party transactions in France remain a problem according to both statistical and legal research. It is not surprising that countries that have a dispersed shareholding ownership structure simply rely on civil penalties to secure compliance of statutory notification requirements. The Russian ownership structure is highly concentrated, like many European countries, which has important implications for the design of effective disclosure rules.

66. However, the absence of a legal basis for investigating ownership structures hampers better transparency in Russia. Apart from investigations of criminal offences, there are no clear legal grounds for regulators to require information on beneficial ownership and control and to provide this to parties requesting the information. Therefore, in line with the requirement for the major shareholder to disclose, clear rights to investigate these cases should be provided to the regulators, and rights to initiate an investigation – to the company, the shareholders (beyond certain threshold) and directors if they suspect that concentration of ownership has occurred. The cases (grounds) when such investigations should be launched need to be specified in law. Only in that situation, liability should be placed on the shareholders.

67. For this to be effective, it would be important that the regulator and investigative bodies work under the principle of the ‘ rule of law’ . In addition, improving the ability of the FSFM to be able to exchange information with international regulators/authorities would be vital to improving disclosure in the case of an enforcement action since the chain of shareholdings often involves other jurisdictions. Also, it is important for a shareholder or a board member to be able to request an investigation, if abuse is suspected.

68. Although corporate governance is the main concern of this report there are broader issues which also need to be considered, in particular with respect to

criminal activity. The Financial Action Task Force[19] (FATF) Recommendations cover two particularly relevant and reinforcing issues in this area. First, they describe a process for identifying beneficial owners and the ultimate controllers of companies. Second, they create a framework for financial institutions to identify their customer and the beneficial owner of any funds deposited. The Russian Federation is a member of FATF. The International Organization of Securities Commissions (IOSCO 2004) has recently adopted principles on client identification and beneficial ownership for the securities industry which OECD countries are expected to eventually adopt.

[19] The Financial Action Task Force (FATF) is an inter-governmental body whose purpose is the development and promotion of policies, both at national and international levels, to combat money laundering and terrorist financing.

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