

Board of Directors at State-Owned Enterprises (SOE) in Russia *

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Introduction

The purpose of this document is to make an overview of the rules and precedents in the functioning of boards at key Russian joint-stock companies with state ownership (henceforth SOEs – state-owned enterprises). The overview briefly discusses the board's legislative framework and looks into such issues as areas of responsibility, key functions of SOE boards, their reporting to government agencies, composition and numerical strength, activities pursued by key board committees, as well as performance evaluation practices and remuneration of directors.

Terminologically, there is a distinction between state enterprises and joint-stock companies with state participation. State enterprises are an institutional and legal form of a legal entity that has no peers in foreign jurisdictions, as, e.g. the Federal State Unitary Enterprise *Mosgortrans* (ground passenger transport in Moscow), or State Unitary Enterprise *Peterburgsky metropolitan*. State enterprises do not own their property but rather hold state-owned property that they possess subject to one of the limited real rights. The Federal Law "On State and Municipal Enterprises" restricts the disposal of property by a state enterprise: in a whole range of transactions it may dispose of such property only with the state's consent. In this overview, we shall not consider governance practices at such enterprises.

In contrast to state enterprises, joint-stock companies own their property; joint-stock companies do not have to seek permission from the state to dispose of any property. Holding stock in a joint-stock company, the state acts as a shareholder and enjoys the same rights as other shareholders. According to the Russian State Property Ministry, by January 2002 Russia had privatized 129,811 former state enterprises, i.e. over 66% of the total enterprises that existed at the outset of privatization in 1992. In 2001, the state sold 9.99 billion rubles worth of stock, while the number of enterprises that were retained under full or partial state control largely stabilized. With each year numbers of privatized enterprises continue to shrink: 2,100 enterprises were privatized in 1998, 700 in 1999, and 150 in 2000. As a result, most former state enterprises had already been privatized during the first 3 – 5 years of privatization.

It is important to remember that it is common practice in Russia for the state to hold a stake indirectly (via its control over the parent company, which, in turn, may have a controlling stake in its subsidiary). Companies with direct state participation would include, among others, RAO UES (the state holds a controlling stake), Russian Railways (RZD) (100 percent owned by the state), Svyazinvest (the state owns 75% minus one share), Aeroflot, Vneshtorgbank, etc. Among companies with indirect state participation would be, e.g., Svyazinvest subsidiaries including Rostelekom, regional telecom operators (North-West Telecom, UTK, Tsentrtelekom, etc.) or Transtelecom which is fully owned by Russian Railways. Although formally such companies do not qualify as SOEs, in actual fact, the state actively interferes in their administration. Some of them report directly to the managing bodies of their parent company bypassing their own boards, in others there are public officers in the membership of the board. In this overview we shall illustrate some of the mechanisms found at board level with references to such companies.

Economists estimate that today the Russian government fully owns more than 160 joint-stock companies, apart from having controlling stakes in more than 540 companies and a blocking stake in almost 1,200 companies. There are also smaller holdings that the Russian government has in another 1,750 enterprises¹. According to the Russian Government, enterprises in which the state retains its share have a strategic significance for Russia in terms of both defense security and state control over key infrastructure components. In addition, the state maintains its control over natural monopolies.

¹ Newspaper *Vedomosti*, 22/12/2004

Positive changes in SOE management practices

Over the past few years the government has been working to enhance the efficiency of state interests in Russian enterprises. Efficient administration, as deemed by the government, translates into improved revenues from dividends paid on state holdings and increased shareholder value at those enterprises where the government plans to sell its share. In its efforts, the state has been focusing largely on boards as managing bodies through which the state could exercise direct influence and control over the companies.

Importantly, over the past five years state control in SOE boards has increased dramatically. Certain regulations were adopted in which SOEs were grouped by their importance to the state and, hence, by the level of ministries involved in the decision-making at enterprises. For more detail about those regulations, see the chapter on ‘Board Composition’.

The adoption of the optional Code of Corporate Conduct initiated positive change in the corporate governance practices in joint-stock companies in general, and at state-owned enterprises in particular. One of the positive shifts was to introduce board-level committees at many enterprises. The vast majority of those committees were not established before late in 2003, and meanwhile most of the committee procedures have not been fully streamlined. In some companies with state participation (RAO UES, Sberbank, Aeroflot) there are audit committees which are expected to help improve internal controls. In many companies, however, although established, the committees are formal and do not even involve independent directors. The committees are discussed in more detail in the chapter ‘Board Activities’.

As for independent directors, they have also become more active lately. The Russian corporate community appears to have a shortage of professional managers willing to serve as independent directors, and suffers from the wary attitudes to the institute of independent directors by controlling shareholders, the state including, for which reason the functions of independent directors at SOEs are assumed by representatives of minority shareholders. There are a number of organizations in Russia today that bring together professionals and help them cope with the functions of independent directors. In the National Registry of professional corporate directors, for instance, out its 120 membership almost 20 sit in boards at companies with state participation. Professional organizations are discussed in more detail in the chapter ‘Board Composition’.

Until 2003 Russian companies overall were improving their transparency and enhancing their boards. In 2004, however, the process slowed down and in certain aspects even began to decline. It was largely caused by the developments at YUCOS, from which many corporates concluded that companies striving for maximum transparency could make themselves vulnerable. At the same time, as shown by the research conducted by the Russian Institute of Directors, Association of Managers and Association of Independent Directors, the quality of corporate governance at Russian companies has been improving steadily.

Legal changes in corporate governance practices

Over the past three years important positive changes have also happened in the legal framework underpinning corporate governance. In particular, the Federal Joint-Stock Companies Law has been significantly updated, with the most recent amendments introduced in February 2004. At the initiative of the Federal Commission for Securities Markets (FCSM, later Federal Service for Financial Markets (FSFM)), the Code of Corporate Conduct (CCC) was approved offering recommendations on the regulation of board activities. So far, CCC has not been fully embraced either by private or state enterprises although some companies have developed their own internal corporate codes based on FSFM’s CCC.

There are also mandatory requirements. Pursuant to FCSM (FSFM) regulations, all joint-stock companies must have included in their annual reporting a separate chapter with disclosures, drafted in accordance with the

specified form and describing compliance with the recommendations of the Code of Corporate Conduct. This, along with the stringent listing requirements of Russian exchanges, help improve the level of corporate governance at the listed enterprises with state participation.

Yet another improvement has to do with the adoption of the new Federal Bankruptcy Law. As a result, the number of “contract” bankruptcies plummeted as the law has introduced additional judiciary procedures. Moreover, bankruptcies can now be initiated only after the creditor’s action to foreclose has failed.

According to the research on corporate governance practices at Russian companies conducted by the Russian Institute of Directors, improvements have been noted in such aspects of corporate governance practices as shareholders meetings, board composition, higher numbers of independent directors, and disclosures. In their paper on ‘Business in 2005 and elimination of barriers to growth’, the World Bank and the International Financial Corporation concluded that it became easier to conduct business in Russia. Having analyzed business environment in 145 countries, the authors of the paper argue that one can open up business in Russia relatively quickly and cheaply, while hire and fire conditions are rather flexible.¹

Key drawbacks in SOE governance practices

Problems in SOE governance can be both objective and subjective. The former ones have to do with issues common to private businesses as well, namely, the overall deterioration of transparency following YUCOS affair, as mentioned before. In addition, there are numerous instances of conflicts of interests and even corruption involving SOE board members. The problem is there for lack of properly prescribed requirements to board members, procedures for the evaluation of their performance and lack of clarity in the objectives that the government agencies should have set for them. These problems will be discussed in more detail in chapters on the evaluation of board performance and remuneration.

Subjective problems in SOE governance are identified in the course of inspections run regularly by the Audit Chamber and various other government agencies. In 2004, the Audit Chamber reported the following reasons for unsatisfactory quality of state property management:

- SOEs do not comply with the Code of Corporate Conduct. Voting on dividends, government representatives fail to follow the instructions of the Federal Agency for the Federal Property Management (FA FPM, formerly the RF Ministry for Property Relations), while the latter at times fails to provide clear directives where they are needed;
- Government representatives do not comply with the established procedures while making decisions on dividends due on government stock;
- FA FPM does not sue companies that fail to remit dividends to the state budget;
- FSFM (formerly FCSM) is not controlling properly SOEs disclosures, which, the Audit Chamber believes, it should be doing.

According to a member of the Commission for the interaction with the Audit Chamber at the Council of Federation, there is no governance in the privatization of government property, and privatization is seen as a random process². The Government has no established policy to prepare enterprises for privatization. The

¹ Expert channel OPEC.RU, 10 September 2004

² Newspaper *Vremya novostei*, №63, 13 April 2004

Russian State Property Fund (FA FPM) has not been vested with enough powers to do preparation and auctioning of stock in companies properly.

SOEs in which, according to the Russian Audit Chamber, state property management is deemed unsatisfactory¹:

Concern Antei, Gazprom, Rosneft, Slavneft, LUKOIL, RAO UES, TVEL, Novorossiisk Seaport, Transneftprodukt, Magnitogorsk Steel, Vanino Seaport, Murmansk Seaport, Svyazinvest, Aeroflot Russian Airlines, Tekhsnabexport, Sovkomflot, Khimprom, Rosgosstrakh, Atomredmetzoloto, Space and Rocket Corporation Energiya, Moscow Kristall, Arzamas Instruments, Fareast Shipping company, Tver Carriage Builder.

Government demands too much dividends from Svyazinvest²

“The Annual shareholders meeting at Svyazinvest did not take place in the absence of relevant directives to state representatives from the Federal Agency for Federal Property Management for them to vote on the agenda,” says the communiqué published by the holding’s press service.

According to market analysts, the true reason for the failed AGM lies in the conflict between the Federal Agency and the Board of Directors of the holding company. Net income at Svyazinvest is derived from dividends paid by the holding’s subsidiaries, which totaled 177 million rubles last year. However, because of the revaluation of assets by the subsidiaries the holding company recorded income of Rbs 1.3 bln. Assets valuation at Svyazinvest grew by nearly Rbs 1 bln., shown according to the accounting rules as net profits. However, dividends for 2004 recommended by Svyazinvest board amounted to Rbs 100 mln., which representatives of the Federal Property Agency did not like. They demanded that dividends be paid on the booked profits, i.e. Rbs 1.3 bln. The amount of dividends to be paid then would have been Rbs 1 bln. To pay such dividends, the parent company would have to sell some of its assets.

The issue of dividends at Svyazinvest was already raised at the board meeting a month ago, but no decision was taken then. After the interdepartmental talks attended by representatives from the Ministry of Information and Telecommunications, the Federal Property Agency revised its demands: it insisted the company pay Rbs 177 mln., i.e. 100% of the holding’s net income for the previous year.

There has never been such friction between the Federal Property Agency and Svyazinvest before. However, observers point out that dividend claims are part of the policies that the Agency has been pursuing lately with respect to many companies with government interest. In this case, they believe the conflict will be resolved in favor of Svyazinvest. The holding’s positions are quite logical, and Svyazinvest can hardly be expected to pay too much, says one of them.

¹ Newspaper *Kommersant Daily*, № 66, 13 April 2004

² Newspaper *Kommersant Daily*, №118, 30 June 2005

Board of Directors: numerical strength and composition

Typically, in the Russian corporate governance practices most boards have representatives of the main shareholder and top executive management. This is equally true of joint-stock companies with a government interest and private companies. At the largest SOEs in Russia, boards have both public officers and the company's executive managers. If the state owns stock indirectly via other SOEs, the board would usually have representatives of the parent SOE. For instance, in UTK, where the controlling block is owned by Svyazinvest, six out of eleven board members represent Svyazinvest. In Transtelecom, a telecom company fully owned by the railways natural monopoly, two out of eleven directors are executive, and the remaining nine are officers of the parent company, Russian Railways (RZD). They all are expected to vote as instructed by RZD. At Aeroflot, where the state has a controlling stock, seven out of eleven board members represent the majority shareholder, so public officers have a bigger proportion of the board seats than the percentage of the government holdings in the company.

The Federal Company Law prescribes directly the minimum numbers requirement for the board membership linking it to the number of shareholders in the company. Pursuant to the latest amendments of 24 February 2004, the board must have at least five directors; at that, the law has retained the previous condition whereby at companies with more than one thousand voting shareholders, the board should have at least seven members, and if the number of voting shareholders in the company exceeds ten thousand, the minimum number of directors in the board is nine.

Table 1. Number of directors

Company	Number of directors	2004 turnover
Gazprom	11	\$ 30 bln.
RZD	11	\$ 23 bln.
RAO UES	15	\$ 22 bln.
Volgatelecom (Svyazinvest as a major shareholder)	11	\$ 0.4 bln.
Svyazinvest	16	\$ 21 bln.
Mosenergo	13	\$ 3.1 bln.
Aeroflot	11	\$ 1.6 bln.
Lenenergo (RAO UES as a major shareholder)	11	\$ 0.73 bln.
ALROSA	15	\$ 2 bln.

However, in reality the majority of bigger and most significant enterprises have eleven members in the board although this is not the number stipulated by law. The maximum strength is to be seen in boards of such large companies as RAO UES, where the board has fifteen directors, or Svyazinvest (see Table 1). For more details on the other classes of directors, including independent directors, representatives of minority shareholders, trade unions and others, see relevant chapters on the composition of boards and their activities.

Composition of the Board

Overall, the board structures at leading SOEs suggest that their composition and strength depend on the size of the company, its “strategic significance” to the Russian government and on the size of state’s holding in the share capital. See below for the presence of various classes of directors in the boards at key SOEs.

Table 2. Board structure

Company	Number of Directors	Representatives of the state	Representatives of the executive management	Representatives of the majority shareholder	Representatives of minority shareholders	Independent directors
Gazprom	11	5	4	-	2	-
RZD	11	9	2	-	-	-
RAO UES	15	7	3	-	5	-
Aeroflot	11	6	2	1	1	1

- Representatives of the state

While in its 2002 White Paper on Corporate Governance in Russia, paragraph 154, the OECD recommends against nominating public officers to the board, Russian practices do not observe it. At the largest SOEs, the boards have officers from the Presidential Administration, while the key sector companies have ministers and their deputies on board. It is not infrequent that the state nominates members from the sectoral committees of the Federal Council. There are instances where boards have representatives from regional governments.

Table 3. Presence of state representatives on boards of key enterprises

Company	State share, %	Board members nominated by the state
Gazprom	38	<ul style="list-style-type: none"> Dmitry Medvedev, Chief of the Presidential Administration (Chairman of the Board); Alexei Miller, nominated by state representatives (CEO)
Russian Railways (RZD)	100	<ul style="list-style-type: none"> Alexander Zhukov, Vice-Premier (Chairman) Igor Shuvalov, Aide to the Russian President; Gennady Fadeev; Vladimir Yakunin, former Deputy Minister
Transneft	75	<ul style="list-style-type: none"> Viktor Khristenko, Minister of Industry and Energy (Chairman)
Aeroflot	51	<ul style="list-style-type: none"> Viktor Ivanov, Aide to the Russian President (Chairman)
Transnefteprodukt	100	<ul style="list-style-type: none"> Vladislav Surkov, Deputy Chief of the Presidential Administration (Chairman)
First Channel	39	<ul style="list-style-type: none"> Alexei Gromov, Press Secretary of the Russian President (Chairman)
Svyazinvest	75% minus 1 share	<ul style="list-style-type: none"> Leonid Reiman, Minister of IT and Telecommunications of the Russian Federation (Chairman) Alexander Anoshkin, Aide to the Chief of the Presidential Administration Sergei Vyazalov, Director of the Administrative Department, Russian Ministry of Finance

		<ul style="list-style-type: none"> • Vadim Stepanov, Chief of the Administrative Service of the Federal Guard Service, • Andrei Sharonov, First Deputy Minister for Economic Development and Trade • Valery Fatikov, Deputy Chairman of the Russian Federal Property Fund • Sergei Storchak, Director, Department of international financial relations, government debt and government financial assets, Finance Ministry
Vneshtorgbank	99,9	<ul style="list-style-type: none"> • A. Kudrin, Minister of Finance of the Russian Federation (Chairman) • D. Aratsky, Deputy Head of the Federal Agency for the Federal Property Management • A. Dvorkovich, head of the Expert Agency of the President of the Russian Federation • A. Drozdov, Director, Department of economy and finance, Government of the Russian Federation • A. Siluanov, Director, Department of Intergovernmental Relations, Finance Ministry
ALROSA	37	<ul style="list-style-type: none"> • A. Kudrin, Minister of Finance of the Russian Federation (Chairman) • I. Materov, First Deputy Minister of Economic Development and Trade of the Russian Federation • Yu. Medvedev, First Deputy Minister of property relations of the Russian Federation • V. Milovidov, head of the Department of financial markets and property relations of the Administration of the Russian Government • A. Tikhonov, Head of Department, Ministry of property relations of the Russian Federation • L. Tolpezhnikov, Head of Department, Finance Ministry.

At companies which the government owns indirectly, through other SOEs, the board would usually have representatives of the parent company as well as public officers. E.g., at UTK (a subsidiary of Svyazinvest), apart from Svyazinvest nominees, there is also an officer of the plenipotentiary representative of the Russian President in the Southern Federal District.

In joint-stock companies where all voting shares belong to the federal state, powers of the general shareholders meeting are delegated to the Federal Agency for the Federal Property Management. Resolutions of the shareholders meeting are executed by the Agency's directive. The shareholding position of the Russian Federation in such companies, which belong to a separate list approved by the Government of the Russian Federation, is set forth by the RF Government, its Chairman or, by his instruction, by the Deputy Chairman of the Russian Government.

For companies key to the Russian economy, the list of state representatives in the board is endorsed by the Russian Government. In January 2005, the Government approved lists of state nominations to the boards at major state companies: gas monopoly Gazprom, oil company Rosneft, diamond monopoly ALROSA, Svyazinvest, Aeroflot and the Russian Railways Company.

Table 4. Lists of government nominations to the boards of major SOEs in 2005	
Gazprom	<ul style="list-style-type: none"> • G. Gref, Minister for Economic Development and Trade • V. Khristenko, Minister for Industry and Energy • I. Shuvalov, Aide to Russian President • F. Gazizullin, former Minister for Property Relations • D. Medvedev, chief of the Presidential Administration • A. Miller, Chairman of the Board of Directors at Gazprom • S. Oganessian, head of Rosenergo • I. Usufov, special representative of the Russian President for international cooperation in the energy sector
Rosneft	<ul style="list-style-type: none"> • I. Artemiev, head of the Federal Antimonopoly Service • S. Naryshkin, head of the administration of the Russian Government • S. Oganessian, head of Rosenergo • S. Sechin, deputy head of the Presidential Administration • Other representatives of Rosenergo, Federal Property Agency, and the Ministry for Industry and Energy of the Russian Federation
ALROSA	<ul style="list-style-type: none"> • A. Kudrin, Ministry of Finance of the Russian Federation • I. Materov, Deputy Minister for Industry and Energy • Yu/ Medvedev, deputy head of the Federal Property Agency • V. Rybkin, head of GOKHRAN • Representatives of various departments in the government, finance ministry, presidential administration and Federal Property Agency
Svyazinvest	<ul style="list-style-type: none"> • A. Anoshkin, aide to the head of the Presidential Administration • B. Antonyuk, Deputy Minister for Telecommunications • V. Belov, director of the department of the Finance Ministry • A. Golomolzin, Deputy Head of the Federal Antimonopoly Service • A. Lukyanchuk, deputy head of the expert agency of the Russian President • L. Pridanova, deputy head of the Federal Property Agency • L. Reiman, Minister for Telecommunications • V. Stepanov, head of the administration at the Federal Guard Service • A. Sharonov, Deputy Minister for Economic Development and Trade

The position of the Russian Federation as a shareholder on various items of the agenda of shareholders meetings is reflected in the directives issued in writing by the FA FPM to the state representative to be voted on at the general meeting. The representative must act subject to the Agency's written instructions and power of attorney.

The legislation also allows for two key agencies to be involved in state property management. It provides for such participation by FA FPM (commonly) and by the Russian Government, following recommendations of the Ministry for Economic Development and Trade (MERT) (for companies from a special list). They would propose lists of state nominations at annual shareholders meetings (AGMs). All other ministries and agencies are supposed to make their suggestions to FA FPM and MERT with respect to their relevant companies, including nominations to the boards. At the same time, many issues are resolved with the adoption of various resolutions. For instance, pursuant to the Russian Government Directive No 91-r, FA FPM instructions to state representatives in the boards of 44 companies should be endorsed by the Government, and in 27 companies the RF Government would be fully responsible for all issues relating to the activities of state nominees to the board.

A list of 27 companies where all key issues are to be approved by the RF Government

- | | |
|---|---|
| 1. Aeroflot Russian Airlines, Moscow | 13. Space and rocket corporation Energiya, Korolev, Moscow Region |
| 2. House Mortgage Credit Agency, Moscow | 14. RAO UES, Moscow |
| 3. ALROSA, Mirny, the Republic of Sakha (Yakutia) | 15. Svyazinvest, Moscow |
| 4. Petroleum Pipeline company Transnefteprodukt, Moscow | 16. Modern Merchant Fleet, Moscow |
| 5. Oil transportation company Transneft, Moscow | 17. TVEL, Moscow |
| 6. Vneshtorgbank, Moscow | 18. Financial Leasing Company, Moscow |
| 7. Gazprom, Moscow | 19. Tekhstabexport, Moscow |
| 8. Izhevsk Engineering Plant, Izhevsk | 20. Russian Railways, Moscow |
| 9. Ilyushin Finance Company, Moscow. | 21. Sukhoi Aviation Holding Company, Moscow |
| 10. KAMAZ, Naberezhnye Chelny, Republic of Tatarstan | 22. Almaz-Antei Concern, Moscow |
| 11. Sheremetievo International Airport, Moscow | 23. Tactical Missile Armament Corporation, Korolev, Moscow Region |
| 12. Oil company Rosneft, Moscow | 24. Russian Electronics, Moscow |
| | 25. Roskhimzashita Corporation, Moscow |
| | 26. Rosgazifikatsia, Moscow |
| | 27. First Channel, Moscow |

It is not easy to discuss efficiency of state nominees to the boards since in most instances they as one in accordance with the directives of their ministries. Such directives are not made public, and it is often impossible to judge about the real motivation of state nominees in the decision-making. At the same time there have been instances when an active position assumed by a state nominee produced results that would be welcomed as generally satisfactory by the shareholders. According to *Kommersant*, in 2002 ALROSA was preparing a contract with the French Societe Generale whereby ALROSA would be granted a loan of \$650 mln against a pledge of its foreign exchange revenues from the De Beers contract to a Jersey offshore vehicle. When discussing the transaction at the Advisory Board of ALROSA, Deputy Finance Minister and head of GOKHRAN Rudakov staunchly opposed the deal claiming that its terms were not sufficiently transparent and open to potential abuse by the executive management. As a result, the transaction was called back by the executives and dropped from the discussions.

- Independent directors at SOEs

In the legislation, the term ‘independent director’ has two interpretations. In the Federal Company Law (Article 83, paragraph 3), an independent director is a member of the Board of Directors at a company with more than 1,000 voting shareholders, who does not represent any interested party in a related party transaction and, therefore, has the right to vote for or against such transaction at the board meeting. The second interpretation of the term is closer to the universally accepted and refers to a member of the Board of Directors who is independent in his decision-making of either shareholders, top managers, employees or other interested parties. The independent director acts in the interests of the company as a whole rather than any interest group.

Criteria of an independent director according to the Code of Corporate Conduct (FCSM)

Specific requirements to an independent director should proceed from the capacity of such director to make independent judgments. For such an assumption, nothing should be impacting

such director's opinion. As a result, independent directors then are deemed to be such members of the Board of Directors who:

- (1) have not been for the last 3 years and are not currently company officers (managers) or employees, or else officers or employees of the management organization;
- (2) are not officers of some other company where any of the company officers are members of the board's nominations and remunerations committee;
- (3) are not affiliated with any officer (manager) of the company (officer of the management company);
- (4) are not deemed affiliated persons of the company, or affiliated persons of such affiliated persons;
- (5) are not parties under such company's obligations whereby they are entitled to acquire property (receive money) valued at 10 or more percent of the total annual income of such party, less their remuneration as board members;
- (6) are not a major counterpart of the company (such counterpart whose transactions with the company account for 10 or more percent of the book value of the company's assets);
- (7) are not representatives of the state.

After 7 years as a board member, no independent director can be considered as such.

In the Russian practice, as well as legislation, they tend to treat independent directors and minority shareholders nominees as being equal. There is a FSFM decree of 15 December 2004, effective since 1 January 2005, "On approval of the Provisions for the activities in trade organization on the securities market". This decree has amended partially certain listing requirements for Tier One "A" Type listing at MICEX and Moscow Stock Exchange. In particular, the listed companies are to set up an Audit Committee at the Board. Such Audit Committee should be headed by an independent director who is not a state nominee. To comply with the decree, Gazprom appointed Boris Fedorov, former Finance Minister and a representative of minority shareholders in its Board, to head the Audit Committee.

Overall, fully independent directors are still rare at Russian companies. As a result, in boards minority shareholders nominees are usually most active. Their goals are closest to those of their counterparts in other countries, viz. to enhance transparency of the company and impact decision-making through voting, discussions and public activity. At Aeroflot, e.g., all three outside directors have been nominated by private holders of a blocking stake, which allows them to conduct their policies. There are no independent directors, nor are there any nominees by institutional investors. However, outside directors effectively offset the dominant control of the government. They are active although it is not clear whether they are capable of representing interests of minority shareholders. Like state nominees, they vote together: there are practically no disagreements among them.¹ It is the same in Gazprom. To represent minority shareholders the Board of Directors incorporated former Finance Minister Boris Fedorov. Conclusions Fedorov has been making on the state of affairs at Gazprom seem to suggest he is well informed and active in the board.

There are examples to the contrary. At UTK (a subsidiary of Svyazinvest), of four outside directors, one is fully independent, two are connected to minority shareholders and one has been appointed by the Plenipotentiary Representative of the Russian President in the relevant federal district.

¹ Standard and Poor's: Corporate Governance Rating at Aeroflot, 2003

There is virtually no legislative requirement to have independent directors at SOEs, with the exception of a few ministerial acts of the like of the above mentioned FSFM decree on the Audit Committees. The companies where the controlling or blocking stake is held by the state admit that they could have independent directors only provided the Government has made a decision to do so. E.g., Anna Belova, Vice-President of Russian Railways (RZD) noted last year that the company was planning to involve independent directors only in subsidiary and affiliated companies. Talking of RZD in particular, she remarked that the company could have independent directors given a relevant resolution by the Russian Premier.

Russian laws do not require that companies have independent directors (including SOEs). Moreover, as recommended by the Code of Corporate Conduct, state nominees may not be independent directors (paragraph 2.2.2. of Chapter 3 in the Code of Corporate Conduct). The Code has incorporated the best foreign and national practices, but it is optional. As a result, although the CCC was adopted with the endorsement of a state authority (FSFM), and the draft Code was approved by the Russian Government, its recommendations for shareholding companies with a state interest have not been actually followed. This is seen in particular in the rather negligible presence of independent directors in companies with a state interest.

The actual impact that independent directors make on SOEs is low. Part of the reason is skepticism that certain government officers have for independent directors. As Dmitry Medvedev, Gazprom Chairman, said the majority of Enron directors were independent but the company collapsed anyway. The underestimation of the role of independent directors by government bureaucrats has had a negative effect on the performance of companies with state holdings.

Now that neither functions nor procedures relating to independent directors have been set clearly, their performance depends primarily on their personal level of involvement. The Code of Corporate Conduct recommends that independent directors at Russian enterprises, including SOEs, should have the following functions (prime areas of activity): development of the company's strategy; evaluation of the executive management in the context of the agreed strategy; resolution of corporate conflicts involving company shareholders. However, the actual role of independent directors at SOEs is minimal although can become rather conspicuous given such director's activity. At state enterprises where the state is in full control, it nominates the majority of the board which votes as one and as such nullifies any potential influence that an independent director may have. In such cases, independent directors have to make themselves heard only during discussions and through public actions.

The Government ignored independent directors nominees suggested by the professional community as possible state representatives

According to the Ministry for Economic Development and Trade, officers that have been nominated to Boards of Directors at key companies may not always have sufficient time to look into their problems in detail. As a result, in 2004 MERT asked professional associations and trade organizations to propose candidates who might be willing to represent government interests at 25 companies including RAO UES, Gazprom, Transneft, Rosneft, Svyazinvest, RZD, First Channel, Aeroflot, Sheremetievo Airport, Vneshtorgbank, ALROSA, etc.

In December 2004, a few associations of corporate directors (Association of Independent Directors, Institute of Professional Directors, Russian Institute of Directors, Association for the protection of investor rights, etc.) came up with their candidates to act as state representatives in SOE boards.¹ Trade associations listed over 100 nominees. The Association of Independent

¹ *Vedomosti*, 22 December 2004

Directors proposed Yevgeny Yasin, the scholarly head of the Russian Higher School of Economics, for Transneft and Svyazinvest boards and Lord Robert Skidelsky from the UK House of Lords, for the First Channel board. The Russian Institute of Directors proposed Igor Kostikov, former head of the FSCM, and Seppo Remes, formerly a director at RAO UES and a current director at OMZ and Pskovenergo. The Russian national association of privatized and private enterprises nominated Igor Zyuzin, Chairman of the Board at the Steel Group Mechel, and the Association for the Protection of Investors Rights recommended Vadim Kleiner from Hermitage Capital Management to Gazprom, Alexander Branis from Prosperity Capital Management and Oleg Fedorov from UFG to RAO UES, and Pavel Teplukhin, President of Troika-Dialog, to Transneft.

However, suggestions by trade associations were ignored. Instead, the state nominated Boris Titov (Delovaya Rossiya) and Farit Gazizullin (former head of the State Property Ministry) as independent directors.

- Representatives of employees and trade unions

In contrast with the German law, the Russian Company Law does not provide for mandatory representation of employees in the Board of Directors. Neither does the Russian Code of Corporate Conduct offer any such recommendation. As suggested by the analysis of Russian SOEs, companies have virtually no representation of employees or trade unions at boards. As we have already mentioned, most of the boards have only representatives of the company's executive management. Importantly, although the Russian Labor Code includes the company management (CEO, top executives) in the employee category, for purposes of this analysis top managers are not affiliated with employees by virtue of their managerial jobs that are radically different from the compliance with instructions and orders by common employees.

- Other forms of representation (women, ethnic minorities)

Note that Russian laws do not stipulate any requirement to incorporate women in the Board of Directors. The research on the balance and gender composition of Russian boards conducted by the Association of Independent Directors in 2004 showed that female directors in Russian companies had a positive effect on the functioning of the board. The companies covered by the research by the Association of Independent Directors had 12% female directors at the boards. In companies with state holdings female directors accounted for 11% of board seats. Overall, this seems to match the total sample.

As the Association's research showed, there are actually fewer women in key jobs than believed desirable by the respondents. Most of the respondents were talking of such key positions as that of the Chair of the Board of Directors, chair of a board-level committee, or corporate secretary.

Representation of ethnic minorities at board level in Russia has not been studied at all and is completely disregarded by corporate governance practices.

Nomination procedures

Procedures for the nomination of state representatives, in general, lack transparency, particularly when nomination involves a variety of state agencies. The decision-making in specific nominations remains non-transparent although the nomination procedure may be compliant with the Federal Company Law.

Board nomination procedure pursuant to the Federal Law “On Joint-Stock Companies”

- 1) No later than by 30 January (unless the company’s charter provides for a later date) the shareholder (-s) that holds at least 2% of the total voting stock would have the right to nominate their candidates to the board of directors. The incumbent Board of Directors has the right to make nominations only provided the number of shareholders nominations is insufficient.
- 2) The proposed candidates shall be discussed by the board of directors which has the right to strike such nominations from the ballot lists to be voted on at the general shareholders meeting only in a limited number of circumstances.
- 3) The board members can be elected only by the general shareholders meeting and only with cumulative voting. The Board of Directors must be fully elected anew by the annual shareholders meeting irrespective of the time when it was elected. Should there be a need to re-elect any of the directors, all of the board should be elected anew.

Before amendments, cumulative voting was mandatory only for companies with more than one thousand voting shareholders. With the 24 February 2004 amendments to the Company Law, now all board members must be elected with cumulative voting. In cumulative voting the number of votes held by one shareholder is multiplied by the number of candidates to be elected to the board, and the shareholder may give his cumulative votes either to one candidate or allocate them among two or more candidates.

Pursuant to the RF Government’s Decree of 3 December 2004, No 738, “On management of federally held shares in open joint-stock companies,” the number of nominations for inclusion in the voting lists proposed by FA FPM to the company must exceed by three the number of seats corresponding to the share of the Russian Federation in the company’s authorized capital. The number of candidates proposed for the inclusion in the list of nominations to the board, audit and mandates commissions may not be higher than the membership of these bodies as approved by the shareholders meeting.

- Degree of political influence on nomination of state representatives

There are few regulations that govern state holdings, and nomination practices may vary significantly from company to company. The key legislative acts include the RF Government Decree of 3 December 2004, No 738, “On management of federally held shares in open joint-stock companies and the application of the Russian Federation’s special right in the governance of open joint-stock company” and the RF Government Resolution No 91-r of 23 January 2003 “On lists of open joint-stock companies with established shareholding positions of the Russian Federation.”

However, practices reveal a considerable impact of personal connections and preferences in nomination and election of government representatives to the board. There are but rare instances where nominations were based on the professional qualities of the candidate. This fact has a negative implication as it affects the credibility of the board member, complicates evaluation of his performance and analysis of his voting on specific issues.

Functions of the Board

In contrast to West European corporates, Russian companies tend to have large concentration of the capital by one shareholder. With the immature capital market, the controlling stake at many enterprises constitutes 50 or more percent of the capital. Hence the specific nature of the boards which are typically dominated by

representatives of key shareholders and lack outside and independent directors. On the other hand, this may lead to a more important role of the boards in key decision-making.

Table 5. Availability and degree of sophistication of key corporate law rules in the Russian legislation and EU acts (level of sophistication in EU acts as the basis for comparison)*

Rule	Russia	EU
Choice between single-tier and two-tier systems of management bodies	Yes (JSC)	Yes, as a compromise between different national models (Draft D 5, R. And D. on SE of 8 October 2001)
Participation of employees in management	No	Yes, as a compromise between different national models (Draft D 5, R. And D. on SE of 8 October 2001)
Takeovers and protection of minority shareholders	Yes (JSC), needs more detailed elaboration	General principles are in discussion (Draft D 13) by virtue of conflicts between national approaches
Group of companies (enterprises)	Minimal and contradictory with regards to subsidiary and controlled companies (Civil Code, JSC), “groups of persons” and affiliated persons	Minimum (D 7 on the notion and reporting, social aspects, Draft D 9 on the “conduct of groups”)
Bankruptcy	Yes, but the legislation needs radical overhaul	Minimum (K. 1995), mostly regulation of conflicts between country norms.
Insider dealing	Minimum, a separate law is needed	There is an outright ban and minimum standards (D).
Liquidation	Yes (Civil Code, Company Law)	No

* Source: *Institute of Transition Economy, 2002*

A good illustration is served by UTK (a Svyazinvest subsidiary) where the board has a broad range of powers including approval of budgets, investment plans and evaluation of the company’s performance. Board meetings discuss most of the significant issues, even those that in other companies may be competences of the executive management. Even the major transactions criteria were specifically set to a lower value of 0.5% of the net assets, which is about USD3.4 mln, for the board to approve them, whereas the legislation at the moment has set it at 25%. Similarly in Aeroflot, where the vast majority of voting shares belong to minority shareholders, the board of directors has been given broad powers including approval of strategic plans, key commercial decision-making and monitoring. The major transaction threshold has also been brought down to 2.5% (about USD 15 mln.) to ensure better control over the executive management. Additionally, the board at Aeroflot has the power to appoint and remove key managers. It also is responsible for strategic and short-term planning.¹

This is in sharp contrast with another SOE, Transtelecom, which is a 100% subsidiary of the state-owned RZD. Their board plays but a nominal role.² They do not monitor interested party transactions, and approve only deals

¹ Standard and Poor’s. Corporate Governance Rating of Aeroflot, 2002

² Standard and Poor’s. Corporate Governance Rating of Transtelecom, 2004

worth of more than 25% book value of assets (about USD 50 mln.). This is rather typical of 100% owned companies with a single shareholder: he is able to fully control the CEO and executive management who are most often also appointed by such shareholder.

- General functions and scope of responsibility

Functions of the Russian boards are prescribed in much detail by the legislation and specifically by the Federal Company Law. Provisions of this law are observed both by private companies and SOEs almost throughout. Board functions can be separated into those that the board may not delegate to other management bodies and those that can be delegated to the board by the general shareholders meeting. Additionally, the company may charge its board of directors with some additional functions and make this decision permanent by prescribing it in the Terms of References of the board. The table below lists the three groups of functions that Russian corporate boards have.

Scope of responsibilities of the Board of Directors which may not be delegated to other company bodies	
1	Defining areas of priority for the company
2	Calling the annual shareholders meeting
3	Approving agenda for the general shareholders meeting
4	Defining the date when to close the register for the general meeting; other matters of preparation and holding of the general meetings
5	Increasing authorized capital by additional issuance within the limits set for the amounts and categories (types) of announced shares, provided the company charter makes it the competence of the board.
6	Offering of bonds and other securities as provided for by the Company Law.
7	Defining the price (valuation) of the property, pricing the offering and redemption of securities as provided for by the Company Law.
8	Redemption of outstanding shares, bonds and other securities as provided for by the Company Law.
9	Establishing and terminating the executive body, provided the company charter makes it the competence of the board.
10	Drawing up recommendations for remuneration and compensations payable to the members of the audit commission (internal auditor), defining the auditor's fee.
11	Drawing up recommendations on share dividends and their payment procedures.
12	Utilizing the reserve and other funds of the company.
13	Approving internal documents of the company, except those internal documents that according to the Company Law should be approved by the general meeting, and other internal documents that according to the company's charter are to be approved by the executive bodies
14	Establishing branches and opening representative offices
15	Approving major transactions valued between 25% and 50% of the book value of assets
16	Approving interested transactions priced under 2% of the assets book value
17	Approving the company's registrar and terms of their contract, or terminating registrar contract

Board competences which may be delegated to the Board by the general shareholders meeting according to the company's charter	
1	Electing the chief executive officer (general director) (delegated to the board of directors almost in 60% of companies, e.g., Tsentrtelekom, UTK, SZT)
2	Electing the executive management board (this function is delegated to the board almost everywhere)
Typical competences granted to the board by the charter (by reducing competence of the executive bodies)	
1	Disposal of shares in subsidiaries
2	Transactions involving key fixed assets
3	Transactions with assets above certain value (e.g., Rbs 3 bln. at RZD or 0.4% of the assets book value at Tsentrtelekom).

- Weaknesses of SOE boards

SOE boards weaknesses result from the extreme dependence of the decision-making on the directives by state authorities. It is particularly obvious in companies where the state holds a controlling block of voting shares. There, the decisive vote on key issues belongs to the state nominees, particularly if they have the majority of seats. The fact that they usually vote together undermines the board's capacity for independent policies, strategies, monitoring of the management and proper disclosures to the shareholders. The board of directors at UTK (a subsidiary of Svyazinvest) is a good example since not only the state nominees in the board, but also the CEO has to vote in accordance with the instructions of the state shareholder.¹

It happens also that on certain matters the management has to report not to the board but directly to the bodies subordinate to the major shareholder. It seriously affects the level of control by the board and limits its capacity for risk management. In particular, the internal audit department at UTK reports directly to the audit commission set up by the major shareholder Svyazinvest, but not to the board. The same happens at the aforementioned Transtelecom whose management makes regular statements about financial and operational plans to the RZD, its parent company, bypassing the board of directors.

- CEO appointment procedures

There is yet another factor impacting the performance of boards at some SOEs where the CEO may be directly appointed by the line ministry bypassing the board. It happened at Gazprom in 2001 when the state as a major shareholder nominated and ensured election of a new CEO Alexei Miller, formerly a Deputy Minister for Energy. Apart from coming from outside the board of directors, this appointment had radical implications for the composition of the board. In particular, soon after Boris Fedorov was nominated as an outside director. In a way, Gazprom served a model whereby state nomination was a positive factor for the company as a whole. In contrast, in such companies as Transtelecom (a fully-owned subsidiary of Russian Railways) appointment of the CEO by the major shareholder only serves to reinforce isolation of the board from key decision-making because such CEO will have fewer incentives to consult with directors.

¹ Standard and Poor's. Corporate Governance Rating of UTK, 2004

Board activities

Since many board procedures have not been prescribed by law, companies themselves lay down plans and functions for the board by approving its Terms of Reference. This document has to be approved by the general shareholders meeting only once. In most instances, the Terms of Reference define the following attributes of the board: powers, election and termination of the board members, functions of the board's chairman, frequency and proceedings of the board meetings, remuneration and obligations of the board members. However, the law does not stipulate any distinctions in the functioning of boards at private companies and at SOEs; as a result, this document is similar in both types of companies.

- Procedures and functioning of SOE boards

In many respects, the efficiency of the board can be inferred from the frequency of its meetings. The majority of large companies stipulate that this frequency should be at least once a month. If there are fewer meetings, it means the board of directors has little influence on the current operations of the company. On the other hand, the table below suggests that at some SOEs the board meets two or three times a month. Such frequency may suggest significant level of control over management that might even lead to complications in the work of the board. One of the board members at RAO UES admitted that a 15 member strong board that is to meet regularly three times a month often faces problems of coordination among its directors, in particular, among state nominees. FA FPM cannot keep up with the directives for most of the discussed matters and the directors fail to make decisions in time on issues at hand.

Table 6. Frequency of board meetings

Company	Frequency of board meetings
Gazprom	Once a month
RZD	One - two times a month
RAO UES	Two – three times a month
Svyazinvest	Two times a month
Mosenergo	Two – three times a month
Aeroflot	Two – three times a month
ALROSA	Once a month

There are other approaches to board proceedings. At UTK (a subsidiary of Svyazinvest), meetings are very frequent, sometimes two times a month, in most instances by proxy. This enables directors to get a much better insight into the issues at hand. At Aeroflot where the board plays an important role in key decision-making it meets two or more times a month. The meetings have a very good attendance rate and intensity, and issues are discussed not only at the time but also outside the meetings.

The Terms of Reference of the Board prescribe also the types of issues that could be put on the meeting agenda, as well as the timing and composition of distributions to board members and committees prior to the meeting for study. In most instances, the applicant asking for a board meeting must state not only the matters to be discussed but also grounds for having them. In this procedure, there are no distinctions between private companies or SOEs.

The quality and timeliness of distributed materials may vary at SOEs and private companies and depend largely of the performance of the corporate secretariat. For instance, board members at UTK (a subsidiary of

Svyazinvest) noted that they would have a lot of background papers for most of the discussed issues. At the same time, in Aeroflot in 2002 some directors deemed both the quality and timeliness of meeting submissions unsatisfactory.

- Interaction among state nominees

As already noted above, there are a few government decrees listing SOEs where state nominees to the board regularly receive directives for matters discussed at the board meetings. The conflict between such practices and the effective Company Law is commonplace since pursuant to Article 71 of the Federal Law “On Joint-Stock Company” board directors should be voting in the best interests of the company rather than separate shareholders. Nevertheless, the contradiction has not been removed.

Procedures for establishing positions of the shareholding Russian Federation at companies that belong to the special list

Proposed nominations to management bodies, audit and mandates commissions of the company, or other proposals for the agenda of the annual shareholders meetings should be submitted by the Ministry for Economic Development and Trade to the Russian Government before 1 December of the year preceding the year of the general shareholders meeting (or 10 days latest before the submission deadline in case of an extraordinary shareholders meeting), complete with all required documents, including:

- (a) suggestions from a federal ministry or agency;
- (b) information about the nominees to management bodies, audit and mandates commissions of the company (references from the HR management of the candidate’s employer);
- (c) background information about the company (share of the Russian Federation in the authorized capital, composition of the company’s management bodies, its audit and mandates commissions, key financial and economic indicators and other requisite data);
- (d) copies of the articles of incorporation and accounts of the company for the past year, duly notarized or certified by the ministry.

- Proposals to ask for an extraordinary shareholders meeting shall be submitted by the Ministry for Economic Development and Trade to the Russian Government at least 10 days before the proposed request day, complete with all enclosures.

Voting by directives is practiced to various degrees at the majority of SOEs, and the directives are usually followed without questioning. However, there were exceptions when early in 2005 several Government representatives in Gazprom at the board meeting voted contrary to the directive approved by the Government and, as a result, the 2005 investment program discussed in the directive was approved. Observers assumed that this could have been inspired by disagreements among various groups in the Government and Presidential Administration.

Issue of FA FPM voting instructions to state nominees in SOE boards

FA FPM serves instructions to representatives of the Russian Federation's interests in the board of directives:

- (a) companies that belong to the special list – together with the federal line ministry or agency;
- (b) companies that belong to the strategic list - based on the proposals of the federal agency or federal authority;
- (c) other companies – separately or, if federal agency or authority has duly presented its arguments, in coordination with such proposals.

As few SOEs have directives on most issues, procedures for state nominees do need improvement. It was proposed, in particular, to stage regular meetings for state representatives in between meetings to agree on common positions in line with the government's standpoint, and to prepare advisory booklets for state representatives at boards.

- Board committees

Most of the active board committees were set up starting 2003, when FSFM (former FCSM) adopted the Code of Corporate Conduct with a recommendation to establish such committees. Since then no other legislative requirements to the committees were introduced except the FSFM requirement to establish audit committees that we have already mentioned. This requirement extended only to companies with Tier One "A" level listing at MICEX and Moscow Stock Exchange.

Some companies started setting their committees even before that. At Aeroflot, the May 2002 shareholders meeting amended the Charter to include a provision requiring three committees at the board level: strategy, audit, and nominations and remuneration committees. Each committee was to be headed by a director who would not be a company's employee, and at least one third of the committee's membership should be retained experts. However, the charter failed to specify any requirements to the independence of the invited experts, or any detailed procedures for the committees.

There are other examples. Between November 2003 and March 2004 UTK (a subsidiary of Svyazinvest) established four board level committees. The company was very thorough setting them up. The majority of audit committee members, e.g., were selected from the minority shareholders nominees, while the nominations and remuneration committee had a tie between nominees of the majority and minority shareholders.

At RZD they set up three commissions in 2004: audit, operations, asset transactions and strategy commissions. However, in the absence of independent or minority shareholders directors in the board these committees do technical work instead of making independent judgment on key management issues.

Although the committees were set up in many companies as recommended by the Code, there have been no detailed specifications of their work, and procedures are too basic, so that few committees can really be held as truly active and efficient.

Evaluation of the Board performance

There is virtually no evaluation of the performance of the board as a governance body in Russian companies. This is equally true of both private and state-owned companies. However, with SOEs, various agencies, in particular the Russian Audit Chamber, regularly assess the performance of line ministries from the point of view of property management. This has already been discussed above in the section describing weaknesses in SOE governance practices.

Most of companies have yet to develop their own internal indicators to evaluate the performance of board members. Their performance is assessed largely against such formal criteria as attendance rate or such indirect attributes as improved financial indicators in the company. At some companies as, e.g., at UTK (a subsidiary of Svyazinvest) the corporate governance and securities department has been actively monitoring also the participation of certain board members and executive managers in other corporate boards and the shares they are holding in other companies.

This is also true of the performance of state nominees in SOE boards. There are currently no mechanisms to assess the performance of state representatives; neither are there any practices to make them liable for underperformance of duties. As a result, government officers find it easier to comply with their board mandates staying passive and voting on the instructions of line ministries, paying no efforts to make their work effective.

There has been lately one performance evolution mechanism that is offered by specialized consultancies. However, the market for these services is only emerging. There are fewer than a dozen such businesses and until recently there has been no demand for their services.

Remuneration of Board members

In accordance with the Russian legislation, remuneration and compensation of expenses that members of the Audit Committee and Board of Directors incurred performing their duties must be authorized by the general shareholders meeting (Article 64, paragraph 2, and Article 48, paragraph 11, of Federal Law “On Joint-Stock Companies”). In the absence of remuneration committees throughout most of the companies, actual procedures in the assessment and payment of the fees would vary significantly from company to company.

The general conclusion is that the bigger is the role of the Board of Directors in key decision-making at the company, the more sophisticated are remuneration procedures and incentives offered to directors. At Transtelecom (a 100% subsidiary of RZD), where the board is almost nominal, no compensation is offered to its directors. At UTK (a subsidiary of Svyazinvest) although the remuneration committee was set up back in 2003, director remuneration and incentives policies had been in place even before that, and the committee did little to change them in any principal way. A positive feature of the company is that they have clear remuneration policies whereby the fee is set up by the annual general meeting at 0.006% quarterly receipts plus 0.4% of the annual net income. These data with actual amounts are published regularly.¹

RAO UES paid its outgoing Board of Directors 104 mln. rubles in remuneration in September 2004²

By end-September 2004 RAO UES paid members of its Board that worked between June 2003 and June 2004, 104.403 mln. rubles (ca. \$3.6 mln.) in remuneration, according to company data.

¹ Standard and Poor's. Corporate Governance Rating of UTK, 2004

² AK&M, 23 November 2004

According to the resolution of the annual general meeting, the total outstanding fees should amount to approximately 430 mln. rubles, or about \$14 mln. at the exchange rate on the AGM day (30 June). The size of the fee was calculated to the approved formula that offers a fee of 12,000 rubles for each attended meeting, and 8,000 for each meeting by proxy. Additionally, the amount included a bonus of 0.05% of net profits in the 2003 fiscal year and 0.05% EVA (economic value added) for each director.

The size of remuneration was about 70 mln rubles total, or ca. 4.5 mln rubles for each of its 15 members. The bonus paid out of net profits of Rbs 24.9 bln. amounted to Rbs 12.3 mln each. The bonus for EVA, which between June 2003 and June 2004 increased by \$1.862 bln. (to \$11.3 bln.), stood at roughly \$930,000. Together, at the exchange rate of 30 June, the remuneration with bonuses totaled \$990,000.

The state nominees in the board could not say whether the fee had actually been paid since their earnings from the participation in the managing bodies of the company are collected into the federal budget. The utilities holding did not comment on how the payments were made or which board members collected the compensation. The company did not comment on further payments towards the outstanding amount either.

It is somewhat different at Aeroflot. The nominations and remuneration committee was established in 2004 there, but the director remuneration system did not change as a result while the committee's functions fall short of the benchmarking standards maintained at international companies of the same size and operations. The remuneration policies have not been formulated or discussed at board meetings. The size of fees payable to various managers has not been disclosed. Outside directors did not receive any remuneration from the company.¹

Hence, until 2003 in key SOEs there were practically no remunerations committees at the board level. In 2003 - 2004 the largest SOEs set up the committees but their procedures are still in the making. Independent directors and invited experts have not been involved sufficiently in the committee work.

¹ Standard and Poor's. Corporate Governance Rating of Aeroflot, 2003

Appendix. Boards at some SOEs

Russian Railways¹

This is the largest Russian natural monopoly with 1.2 million employees and a turnover of USD 23 billion. Currently the company is in the process of restructuring that is to spin off dozens of subsidiaries.

The company is fully owned by the state and managed from the center. The Board of Directors is approved by the Government and has 11 members now. Sitting on the board are ministers or their deputies from the following state agencies: Russian Vice-Premier is the Board's Chairman; there are officials from the Ministry of Transport, Anti-Monopoly Ministry, State Property Ministry, Ministry for Economic Development and Trade, Railways Ministry, Office of the Cabinet, Administration of the President, Ministry of Finance and the company's CEO V.I. Yakunin.

The key issues for board discussions are the company's budget and investment projects. State representatives vote in accordance with the instructions they receive from the State Property Agency and the Ministry for Economic Development and Trade. Board assessments are also done by the Economic Development Ministry, which is currently considering measures to enhance the contribution from state representatives.

The RZD board has a commission to divest a Federal Passenger Railways company and a committee on growth and restructuring. They are composed of both RZD board members from the state, and officials from departments and ministries, together with RZD employees and experts.

The company has the Code of Corporate Conduct and a Corporate Governance Program; the company is currently working to obtain a corporate governance rating.

The Executive Board has looked into the possibility to introduce the institute of independent directors. Independent directors have already been elected to the boards of subsidiaries, while RZD has approached such entities as the Association of Independent Directors, Institute of Professional Directors and Russian Institute of Directors with a request to draw up a list of potential nominees.

Lenenergo²

This company is the largest power generation operation in the North-Western part of Russia. Among its shareholders are RAO UES, a Finnish Fortum, minority shareholders and the administrations of St. Petersburg and Leningrad Oblast. The Board has 11 members: four members from RAO UES, the CEO, two officers of Fortum, a representative of minority shareholders, an independent director and two governors – of Petersburg and Leningrad Oblast.

The governors have been rather active in the Board, primarily where it comes to corporate investments. They both want to see capital expenditure and investment projects implemented in their respective territories - in the city of Petersburg and in Leningrad Oblast.

¹ The chapter is based on the interview with Anna Belova, a board member and Vice-President of RZD (Russian Railways).

² The chapter draws on the interview with Lenenergo board member Dmitry Shtykov who is also Director General of the Institute of Professional Directors.

Because of their busy schedules, governors do not always have sufficient time to attend board meetings in person, and their positions would then be supported by their representatives (assistants). However, they still attend more than half of the regular board meetings.

The most active board members are representatives of RAO UES and the Finnish shareholder. For the former, RAO UES would draw up a list of instructions for voting on all items of the agenda. On many issues RAO UES agents can vote independently, and their instructions would then refer to RAO UES's 'best interests'.

The Lenenergo Board of Directors has two committees: audit committee and business analysis committee. However, their work is still to be properly arranged. The Audit Committee has not been working for the actual lack of powers, in the absence of Terms of References approved by the Board. The restructuring working group has but occasional meetings once every six months.

In 2005 the efficiency of the Board work was undermined to a degree by contradictions between RAO UES and Lenenergo management on some of the issues, including key corporate performance indicators, management remuneration, acquisitions, etc.

Officers from some of the RAO UES departments conduct annual assessments of the managerial qualities of their subsidiary CEOs against a vast check list of items to evaluate; it is distributed to RAO UES agents (including board members) for them to fill in. Their assessments make grounds for the decision to extend or end the CEO's term of office.

The board's performance is not currently rated although the assessment method has already been developed by the Institute of Professional Directors and is in the process of endorsement by relevant RAO UES departments.

Board members draw remuneration for their work in the board and receive compensation of their board-related expenses. The remuneration proper has a fixed attendance fee of 300 - 900 rubles per each regular or absentee meeting, and a percentage of announced dividends of ca. 1% of the due dividends amount. This is an efficient system that might help stimulate dividends but does not help improve the company's valuation.

RAO Unified Energy Systems¹

RAO UES is one of the largest Russian natural monopolies. The controlling interest in the company belongs to the state. The company's board has proportional representation of key shareholders, and the majority of seats belong to state representatives. The board has a membership of fifteen.

The company's representatives speak highly of the attendance of board meetings. Directors study the materials and actively contribute to the discussions. Each director gets a full package of materials in time.

State representatives are active too, voting in line with the directives of the government (on certain issues) and State Property Ministry (also on a separate list of issues) pursuant to the government's order.

The Board meets once a month every last Friday of the month. Apart from regular meetings, there are many absentee meetings. On average, RAO UES holds two – three board meetings a month.

The Board has committees on nominations and remuneration, audit, assessment and reform. Some of them are chaired by directors nominated by the state (Ilya Yuzhanov, chair of the Assessment Committee), others are retained professionals (David Herne, Seppo Remes, former RAO UES directors; Andrei Bugrov, a member of the Board).

¹ The chapter is based on the interview with Andrei Gabov, head of the corporate governance department at RAO UES.

There is no separate procedure for the evaluation of board directors. The main assessment criterion for board members, like in many other companies, is attendance. The system of directors remuneration at RAO UES takes into account not only attendance of the board meetings, but also such economic performance indicators as net profits and capitalization.

RAO UES has lots of subsidiaries too. Their boards are structured so as to take into account interests of minority shareholders and local communities, and the professional aspect: there are many independent professionals retained to help the board.

Currently subsidiaries are introducing board committees. The companies have developed and implemented modern dividend policies.

Svyazinvest¹

The company is the largest telecom holding in Russia that owns the majority of regional fixed telecommunications networks. The government has retained 75% minus one share in the holding. One of the key functions of Svyazinvest is to coordinate subsidiaries, including their boards of directors.

The majority of seats at subsidiaries boards are held by Svyazinvest representatives. At the same time, in some subsidiaries (Uralsvyazinform, Tsentrtelekom, Central Telegraph) there are representatives of the Federal Agency for State Property Management (former State Property Ministry) and the office of Presidential Representative in the Federal District.

All subsidiary companies have committees on audit, nominations and remunerations, strategic development and corporate governance. Their members are state representatives as well as independent directors and the holding's agents. Svyazinvest is one of the few SOEs to nominate independent directors at subsidiaries with its votes. In MGTS they nominated Igor Rodionov as the one with substantial experience of the board committees. The purpose of the nomination was to set up the audit and nominations/remunerations committees at MGTS. Independent directors are present in boards at the majority of subsidiaries since 2004. Some of them have seats in the boards of several companies. For instance, Valery Degtyarev is a board member at Rostelecom, Volgatelecom and Dalsvyaz, and the chair of the audit committee. In some regions, the role of independent directors goes to presidents of the local telecommunications universities - in Petersburg, Samara and Novosibirsk.

At Svyazinvest subsidiaries independent directors dominate. In those companies there usually is no more than one executive director, the company's CEO. In some subsidiary companies, however, there are no executive directors.

The holding's representatives in the board always have a uniform position. Materials supporting board meetings at subsidiaries are distributed to all board members at least 14 days prior to the meeting, for the holding's departments to coordinate their opinions of each of the items of the agenda. Basing on their opinions, the holding formulates its uniform position for all Svyazinvest representatives, which is ultimately finalized right before the meeting.

The system of board remuneration has changed radically in recent years. In the past, when companies did not have any independent directors, there was no fixed fee to board directors, and the only linkage was to economic performance. Now all board members are paid a quarterly salary of 200,000 roubles, and an annual bonus based

¹ The chapter is based on the interview with Irina Ragozina, member of the executive board at Svyazinvest and corporate governance director.

on the economic performance. The yearly remuneration formula takes into account net distributed profits, and EBITDA under the IAS. This annual bonus is not unlike to the annual fixed salary in size.

There are some other, additional incentives offered to directors. At North-West Telecom, the annual remuneration also depends on the relative capitalization growth vis-à-vis other subsidiaries. Board committee members receive an additional remuneration of 40,000 rubles every quarter.