OECD Russia Corporate Governance Roundtable

BOARD FORMATION: NOMINATION AND ELECTION IN OECD COUNTRIES AND RUSSIA

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The purpose of this report is to present background information to participants of the OECD Russia Corporate Governance Roundtable organized for October 25 and 26 2012 in Moscow, Russian Federation. This paper addresses the main elements of the framework for nominating and electing members to the board of companies. This is accomplished, first, by describing the relevant corporate governance standards developed by the OECD, which are also complemented with selected best practices of jurisdictions participating in the work of the OECD Corporate Governance Committee and the OECD Working Party on State Ownership and Privatisation Practices. Then, the report turns to the Russian Federation and aims to describe the current rules and practices in board formation. It also describes some of the key aspects of the manner in which board of directors operate in Russia. Finally, the report aims to facilitate the identification of areas where Russian rules and practices could benefit from OECD standards and country experiences.

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1. The nomination and election of the members of its board of directors is one of the two most crucial events for a company. The other is the appointment of the senior management team, including the CEO. Both events are interdependent in a critical manner, depending in great part on the ownership structure of the company, with the board determining the composition of the management team or with the CEO (or controlling shareholder) influencing the composition of the board.

2. The OECD Principles of Corporate Governance (hereafter "the Principles")[1] acknowledge the importance of board formation as well as the need for rules and practices to adjust to different ownership models. This is reflected in the outcome-oriented nature of its recommendations, as well as in the Annotations that accompany the Principles. They elaborate, explain and indicate the range of policy measures which have proved useful in achieving those outcomes. Furthermore, in 2006 the OECD published the Methodology for Assessing Implementation of the OECD Principles of Corporate Governance (hereafter "the Methodology") to underpin the dialogue on implementation of the Principles in different jurisdictions and provide a framework for policy discussions.

3. Given the specific corporate governance issues facing State-owned enterprises (hereafter "SOEs"), the OECD has also developed the OECD Guidelines on Corporate Governance of State-Owned Enterprises (hereafter "the Guidelines"). They are based on and are fully compatible with the Principles, but are explicitly oriented to specific corporate governance issues of SOEs. Addressing the State as an owner, the Guidelines establish the core elements of a good corporate governance regime. As the Principles, they provide standards and good practices, as well as guidance on implementation.

4. The following section of this chapter describes some of the most relevant provisions of the Principles, the Annotations, the Methodology, and the Guidelines in relation to board formation. The second section develops on how these standards have been implemented in OECD and some non-OECD jurisdictions. It provides good practice examples identified by the OECD Working Party on State Ownership and Privatisation Practices, as well as the results of countries reviews conducted by the OECD Corporate Governance Committee.

1.1. The OECD corporate governance standards

5. The Principles address issues related to board formation in different perspectives. They specify the desirable outcomes expected of board behavior as well as the role of shareholders and the board itself in determining such outcomes. Box 1 transcripts the most relevant principles.

6. Principle II.A stipulates that it is a basic shareholder right to elect and remove members of the board. Principle II.C.3 further states that shareholders' participation in the nomination and election of the board should be facilitated. The Annotations specify that shareholders should be able to vote on individual nominees or on different lists of them. The Principles do not advocate the right of any shareholder to nominate and does not make any distinction between different classes of shareholders. In turn, the Methodology requires effective mechanisms enabling shareholders to hold the board to account in case of inadequate performance, such as meaningful opportunities to address shareholder concerns at the shareholders meeting or vote against board members, among others. These mechanisms should be facilitated by the jurisdiction's nomination framework.

Box 1. Recommendations of the OECD Principles relevant to board formation

Principle II.A. Basic shareholder rights should include the right to: (…) 5) elect and remove members of the board.

Principle II.C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures that govern general shareholder meetings: (…) 3. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval.

Principle V.A. Disclosure should include, but not be limited to, material information on: (…) 4. Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.

Principle VI.D. The board should fulfil certain key functions, including: (…) 3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning. (…) 5. Ensuring a formal and transparent board nomination and election process. 6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions. 7. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

Source: OECD Principles (2004).

7. Principle V.A.4 is concerned with transparency of the process and calls for disclosure of key aspects of the board formation process. The Annotations promote full disclosure about the nomination process and about the experience and background of candidates, and briefly describe practices regarding proxy voting, nomination committees and the role that independent directors may play in them.

8. Principle VI.D.5, states that the board has an essential role to play in the nomination process, as the board (or a nomination committee) has responsibility to make sure that established procedures are transparent and respected. The Annotations add that the board has a key role in identifying potential members for the board with the appropriate knowledge, competencies and expertise to complement the existing skills of the board and thereby improve its value-adding potential for the company.

9. The Methodology offers practical considerations to assess compliance, always with a view to functional equivalence and to achieving desired outcomes, rather than promoting one-size-fits-all recommendations. It argues that often it is not the implementation of individual principles what is crucial to overall outcomes, but rather the interaction and consistency of the many elements of a corporate governance framework. It develops a number of specific considerations, mapping practices which are consistent or inconsistent with the Principles:

> "(…) practices in many jurisdictions and companies can be very opaque and the election process highly restrictive as when a list of candidates is presented for election with no possibilities to oppose individuals or to propose other lists. In some jurisdictions, there are prohibitions on management and the board acting improperly in soliciting proxies (e.g. paying shareholders for their proxies). Companies with a controlling shareholder and/or block-holders can also be opaque even though it is within their rights to appoint the board.

> Some jurisdictions are moving to encourage or mandate the use of nomination committees comprising at least a majority of independent board members. Such committees are especially important in jurisdictions where the CEO/Chairman or executive board members have traditionally selected new members of the board and the shareholding structure has been diffuse. In other jurisdictions, major and/or controlling shareholders have frequently been directly involved in the nomination and election process so that the need for an independent nomination committee is less pressing, but the need for transparency is all the more greater. Given the fact that company law may be unsuitable in mandating transparent procedures, a number of jurisdictions have found it appropriate to use codes/principles to call for open transparent election processes." (OECD Methodology, 2007, p. 118)

10. The Annotations add that the board must set and enforce clear lines of responsibility and accountability throughout the organisation, as well as ensuring appropriate oversight by senior management, while retaining final responsibility. The nomination and election rules and practices should be shaped in a way to assist shareholders in the task of electing competent board members for these functions, and provide sufficient incentives for the board members to adequately pursue these functions.

11. Standards specific for SOEs are developed in the Guidelines. In its introductory part, the Guidelines state that "a major challenge is to find a balance between the State's responsibility for actively exercising its ownership functions, such as the nomination and election of the board, while at the same time refraining from imposing undue political interference in the management of the company".

12. Guideline II.C addresses the issues of the State acting as an owner and recommends that the State let SOE boards exercise their responsibilities and respect their independence. The Annotations further elaborate on this and explain that the ownership entity should focus on SOE boards exercising their responsibilities in a professional and independent manner. It stresses that individual board members should not act as representatives for different constituencies and carry out their duties in an even-handed manner with respect to all shareholders. It means that board members should not be guided by any political concerns when carrying out their board duties. In the situation when the State is a controlling owner, the ownership entity should avoid electing an excessive number of board members from the State administration. Employees of the ownership entity, professionals from other parts of the administration or from the political constituencies should only be elected on SOE boards if they meet the required competence level for all board members, and if they do not act as a conduit for undue political influence.

13. The Annotations further suggest that it is particularly important to clarify the respective personal and State liability when State officials are on SOE boards. Guidelines or codes of ethics for members of the ownership entity and other State officials serving as SOE board members could be developed by the co-ordinating or ownership entity. These Guidelines or codes of ethics should also indicate how confidential information passed on to the State from these board members should be handled.

14. With regard to political objectives, the Annotations prescribe that direction should be channelled through the co-ordinating or ownership entity and expressed as enterprise objectives rather than imposed directly through board participation. Furthermore, Guideline III.D prescribes the need to facilitate the participation of minority shareholders in shareholder meetings in order to allow them to take part in fundamental corporate decisions such as board election.

1.2. Experiences from country implementation

15. This section shows how the OECD standards described in the previous section have been implemented in different jurisdictions and within a diverse variety of frameworks. Good practices identified for both private companies and SOEs are summarised below.

1.2.1. Peer review on board nomination and election

16. The OECD has been working for many decades on helping strengthen the corporate governance frameworks of emerging and developed economies, providing a platform where they can share experience, identify best practices and together develop international standards and guidelines, like the Principles. An essential part of this process is to understand that implementation of standards requires adaptation to varying legal, economic and cultural circumstances. For this reason, since 2010 the OECD Corporate Governance Committee is conducting a series of thematic country reviews examining specific areas of corporate governance. These reviews provide recommendations concerning good practices and assist market participants and policy makers to respond to emerging risks in their challenge of implementing the Principles.

17. In 2012 the OECD published a review of the corporate governance framework and practices that specifically relate to the nomination and election of the board (OECD 2012 a). It covers 26 jurisdictions, including in-depth reviews of Indonesia, Korea, the Netherlands, and the United States of America. The key outcomes of these reviews are summarized in the following paragraphs.

1.2.1.1. Board nomination processes and shareholders' rights

18. One of the key factors in analyzing board formation processes is often assessing the actual role of boards (de facto rather than de jure). In jurisdictions where companies are tightly controlled by a family group the role of boards is limited to oversight of related party transactions (conflicts of interest) and the integrity of the accounting system. Such boards do not appoint the management nor oversee the corporate strategy, as generally recommended in the Principles. It is often the controller or corporate group that does that, instead. This limited role of the board has an impact on board formation and raises questions about the board's independence, especially when members are mostly appointed by a controlling shareholder. This is the case in Korea and Indonesia, where company groups and families are the largest shareholders.

19. By contrast, in the United States corporate boards do fulfill the duties of appointing management and overseeing strategy, as the legal role (de jure) of the board is traditionally one of being the steward of the company. The power of the board in the U.S. is vast and goes beyond that of boards in many other countries. This is most clear under Delaware law,[2] where shareholders, regardless of the percentage of shares they own, are not free to submit any proposals to the AGM. They are instead limited to vote on decisions presented by the board for their consideration.

20. For example, while in the United Kingdom or Australia shareholders can decide to close the company or change its charter, the submission of such a vote to the AGM in the United States is the prerogative of the board. This is important in a takeover situation, where control over anti-takeover provisions (such as poison pills) is crucial in the U.S. landscape. At the same time, and despite recent reforms, U.S. boards have the prerogative of self-nominating with very limited interference from shareholders. This puts the nominating process, in practice, under the influence of the CEO. Until 2004, in the Netherlands supervisory board members under the "structure" corporate law regime (comprising about one third of listed companies) could appoint themselves. Since then this has become a shareholder right.

21. In practice, in many jurisdictions board nomination is influenced both by these formal processes and by the use of informal networks. The traditional approach is that those responsible for

nominating candidates essentially use informal networks and personal acquaintances, especially of the controlling shareholders. This practice is often referred to as the "old boys' network" and at its worst has led to reduced board diversity and to locality based boards (Knyazeva, et al 2011). Korea and Indonesia still actively use this approach while the Netherlands has decreased this practice in favor of the use of placement agencies. Increasing board diversity in the Netherlands is also related to the recent introduction of limits on the number of boards individuals may serve on. In the United States and the United Kingdom, where shareholding is not concentrated, boards tend to find directors who are already well known to at least one sitting director (Trautman, 2012).

22. In some jurisdictions, such as the Netherlands and the United States, companies are more frequently resorting to formal board evaluations to set requirements for potential candidates. They then use advisors to locate them. In Europe, one study concludes that boards are now using defined competencies to create member profiles, rather than simply asking for CEO/CFO standard backgrounds. This is compatible with an increased use of board evaluations, outside consultants and stronger nomination committees. Another key feature has been the tendency to set up nomination committees charged with specifying a profile of directors desirable for the board. They tend to be combined with a remuneration committee or corporate governance committee. In most of jurisdictions, establishment of independent nomination committees is recommended, but the situation with implementation varies.

23. A marked feature of all reviewed jurisdictions is the greater emphasis on minority protection and the related reliance on independent board members. This has an effect on the way boards are nominated and elected. Among the reviewed jurisdictions there is a general requirement as to the proportion of independent members on the board and this also is reflected in the composition of the nominations committee. Motivations, however, differ. In the United States, the greater resort to independent directors as well as their role in nomination and audit committees can be seen as redressing the balance of a board/management centric system. Independence is defined mainly in relation to management. In other reviewed jurisdictions, such as Korea and Indonesia, independence revolves around the relation of a candidate with controlling shareholders. However, in these two jurisdictions there are no special arrangements for nomination and election, and independents need to be appointed with the explicit or implicit approval of the controlling shareholder.

24. In Korea, in particular, for the largest 116 companies there is a requirement for at least half of the board to be composed of outside directors, who must meet certain requirements of independence. They must also comprise two thirds of the audit committee, including holding the chairperson post. These outside directors are also required to serve as a majority on the "outside directors nominating committee" that reviews and screens candidates prior to the board's nomination of all director candidates for AGM consideration, including those for "insider director" positions. Other listed companies, below a given threshold, are only required to appoint one outside director. Some 30 of these companies have voluntarily established an outside director nomination committee. The rest of the listed firms, some 1.600 companies, have predominantly boards composed only of insiders.

25. The peer review report claims that there might have been an over emphasis by nominating committees (and shareholders) on the search for independence, to the neglect of qualifications. To address this possibility, the Dutch Corporate Governance Code (issued in 2003) recommended that the size and composition of the supervisory board takes into account the nature of the business, its activities and the desired expertise and background of board members. Revised in 2008, the Duth Code now also recommends aspects of diversity in the composition of the supervisory board that are relevant to the company, and also requires a statement about what specific objective is pursued by the board in relation to diversity. Diversity issues, especially concerning gender, are increasingly being urged on nomination committees in almost all reviewed countries.

1.2.1.2. Shareholders' right to elect board members

26. Principle II.C.3 states that shareholders' participation in the nomination and election of the board should be facilitated. The degree of participation and its effectiveness is determined among other things, by the ownership structure and the corporate governance framework. Around the world, there is a general practice to permit shareholders to present to the board candidates for election. Three of the reviewed jurisdictions have thresholds for the exercising this right: 10% in Indonesia (high by international standards) and 1% in Korea and the Netherlands. In the United States, regardless of their ownership levels, shareholders face restrictions in accessing the company proxy documents (the actual voting card mailed to shareholders for voting for board members), which makes it extremely hard (and expensive) for them to nominate candidates.[3] They typically do this only through a proxy contest, which are rare and not very successful.

27. With regard to the voting process, contested elections are rare and this appears to be the case around the world. In the case of many companies, a dominant shareholder makes the contesting process pointless. In Chile, Italy and Israel, however, there are special arrangements for non-controlling shareholders to have a chance to obtain collective action, such as by the use of special voting mechanisms. These mechanisms are often adopted in response to the judgement that independent directors nominated and voted by controlling shareholders might not bring objectively independent judgment to the board. Even though cumulative voting is often permitted (especially in Latin America), in practice it is not widely used with the exception of Chile, where public pension funds are encouraged to cooperate. Although widely recommended, cumulative voting presumes shareholder cooperation, which is rare except in cases where there are several small block holders.

28. In a number of jurisdictions, elections might be conducted by show of hands rather than by polling actual votes. This is not in the spirit of the Principles. The Annotations to Principle V.A.8 note that "as a matter of transparency, procedures for shareholders meetings should ensure that votes are properly counted and recorded, and that a timely announcement of the outcome is made." Electronic voting will hopefully lead to curtailing show of hands voting at shareholder meetings in the near future.

29. In the case of the United States and the Netherlands, it is clear that shareholders are often in direct contact with companies to solve issues directly, even before the AGM. This might lead to different board nominations, but would be unobservable for outsiders. Campaigns in the United States and elsewhere against some board members (by abstaining from voting, for instance) can also ultimately have the same effect. In other jurisdictions there may be no contestable elections, but low voting for some members conveys the same information.

1.2.1.3. Degree of disclosure about the nomination and election process

30. Principle VI.D.5 calls for the board to ensure a "formal and transparent board nomination and election process." A number of companies in the United States and the Netherlands, and also in other countries of Europe, are resorting to board evaluations and recruiting agencies in establishing desirable profiles for board membership. These processes are often disclosed. However, the nature of the market for board members will always be imperfect as long as personal contacts are important. Overall, however, in many jurisdictions the process of appointing boards is becoming more transparent, with full disclosure about the qualifications of candidates. Critically, this includes memberships of other boards that may point to conflicts of interest. Challenges still remain, though.

31. In Korea, information about candidates' backgrounds must be published by the company at least two weeks prior to the AGM, including the candidate's name, career information, qualifications, the nomination process, the recommender, the relationship between the recommender and the candidate, the relationship between the candidate and the largest shareholder, and the reason for the

nomination. There is no requirement to disclose which other boards that candidates serve on or to limit their number, except that they do not qualify as an outside director if they are also on the board of an affiliated company.

32. In Indonesia, all listed companies are required to produce annual reports including a board report with statements on corporate governance. However, the provision regarding the content of reports on corporate governance does not include the nomination and election process, except for the description of a nomination committee. This results in a mere reiteration of relevant code and rules in annual reports giving no meaningful information on board formation processes. Shareholders receive an invitation to the AGM more than 14 days before the meeting via an advertisement in newspapers. The content of the invitation includes the date, time, location, agenda and notification that the materials to be discussed in the meeting are available at the company's office. The invitation does not include the names of the candidates, let alone sufficient information regarding candidates' qualifications. In the case of most listed companies, in practice, this means that they fail to provide such fundamental information before the AGM unless shareholders visit the company offices themselves. There is no mandate for listed companies to maintain a company website and therefore no rules with respect to publishing material information on the website.

33. In the Netherlands, the Civil Code sets out the requirements for the provision of information about board candidates, including: age, profession, the amount of shares the candidate holds in the company, and other relations or experience relevant to the candidate's functioning as a board member. The motivation for the recommendation or nomination must also be disclosed, and generally includes an explanation of how the candidate complies with the profile of skills and experience being sought for the board. In case of reappointment, the candidate's functioning as a board member must be taken into account. These legal requirements are supplemented by the recommendations of the Corporate Governance Code concerning independence and other matters. Each board candidate is voted individually. Listed companies are required to report on their web site, within 15 days of the general meeting, the number of shares for which votes have been validly cast, the proportion of the share capital represented by those votes, the total number of votes validly cast, the number in favor, the number against, and where applicable, the number of abstentions.

34. In the U.S. the disclosure requirements have been recently enhanced and are one of the most efficient policy tools at the disposal of the federal authorities. The Securities and Exchange Commission (SEC) disclosure rules require a high level of disclosure regarding the nomination and election process, including:

- Discussion of the charter of the company's nominating committee, if it has one;
- A statement about whether the nominating committee has a policy regarding shareholder recommended director candidates and a description of the material elements of that policy, such as whether the committee will consider shareholder-recommended director candidates;
- A statement that the company does not have a policy regarding shareholder recommendations for director nominees, if applicable, and the basis for the board of directors' view that it is appropriate for the company not to have such a policy;
- A description of the procedures shareholders must follow to submit director recommendations;
- The specific minimum qualifications that the nominating committee believes must be met by a nominee, and any specific qualities or skills that the nominating committee believes are necessary for one or more of the company's directors to possess;
- The nominating committee's process for identifying and evaluating nominees for director, including nominees recommended by shareholders, and any differences regarding how the nominating committee evaluates nominees for director based on whether a shareholder recommends the nominee, and whether diversity is considered in identifying director nominees;

- A statement identifying the party who recommended the director nominee, such as a shareholder, non-management director, chief executive officer, other executive officer, third-party search firm, or other specified source;
- A description of any fees the company pays to any third party or parties to identify or evaluate or assist in identifying or evaluating potential nominees, and disclosure regarding the function performed by each such third party; and
- Identification of any shareholder-recommended nominee by a shareholder or group that beneficially owned more than 5% of the company's voting common stock and disclosure regarding the recommending shareholder.

35. Board candidate's background and experience must also be disclosed under SEC rules for each director and director nominee. This information must be included in the proxy statement of the company and provided to shareholders before the company's AGM. The company must provide the name, age, positions and offices held by each director or director nominee at the company, term of office at the company, and the person's business experience. The business experience disclosure covers background and directorships.

36. Within four business days from the date of the meeting, companies in the U.S. are required to report the results of the election of directors. Companies report the number of votes for and against, as well as the number of abstentions and shares held by brokers for which there was no authority to vote, for each candidate. This information however does not identify the names of the shareholders that voted or the number of votes they cast for each candidate.

1.2.1.4. Overall functioning

37. The election and nomination of board members should facilitate the formation of a board that is capable of performing the key board's functions advocated in the Principles. As noted above, however, there is a big difference between de jure and de facto roles of the board. This is particularly relevant with respect to corporate strategy and appointing management. In controlled companies, as in Korea and Indonesia, there is a great deal of evidence pointing to central control of these vital corporate decisions. In the case of Korea, the board does have formal powers but, de facto, the power is wielded by the corporate group. Indonesia is somewhat different since the supervisory board is more in the nature of an advisory body, but the management board is also elected, tending to confirm the supervisory board nominations of the CEO and senior managers. This is a practice also followed by most firms in the Netherlands.

38. In many jurisdictions, the definition and enforcement of director's duties underpins the functioning of the board. It might be more influential than its composition in determining what duties are performed. Korea has enacted stronger regulation to prohibit self-dealing and requiring stricter reviews of related party transactions, where a two-thirds majority approval and strengthened disclosure are required for transactions involving directors, major shareholders or their families.

39. The United States is a special case in terms of board duties, since company law recognises the predominance of boards as company stewards. However, accountability of the board to the company is provided by strong and enforced fiduciary duties, even though the business judgement rule also gives them a great deal of protection.

40. If boards of controlled companies have little role in strategic functions and in appointing senior management, they do frequently appear to be used in two key areas: monitoring and managing potential conflicts of interest, such as related party transactions (Principle VI.D.6); and ensuring the integrity of the corporation's accounting and financial reporting systems (Principle VI.D.7). These are two areas where board nomination and election might be crucial. Staffing special board committees

with independent directors is also a general trend, and certain jurisdictions reinforce it with special voting and nomination procedures, as in Italy.

1.2.2. Good practices from OECD countries

41. As shown in the previous section, the procedures for the nomination of candidates vary widely, with both advanced and developing economies struggling to implement mechanisms to achieve the desired outcomes. Laws and regulations do not always guarantee the best framework for board formation and the private sector plays an important role in improving board practices, both through voluntary standards and corporate leadership at the boardroom.

42. The objective is the formation of competent boards, capable of objective and independent judgement. For that it is widely recognised as a good practice to facilitate the right of shareholders to nominate candidates and have a significant role in their appointment. Also, for boards to develop specific policies for identification of the best skill composition of the board, which could help building an efficient team and identifying potential candidates to fill lacking competences. The absence of a good balance of necessary skills was highlighted by the recent financial crisis:

> "Perhaps one of the main lessons of the financial crisis regarding the behaviour of boards was that ideal of boards capable of objective independent judgement was not a guarantee for effective monitoring of management. Board member competence is certainly important, but there is no necessary trade-off between independence and competence." (Kirkpatrick et al, 2012, p. 40)

43. In 2008, the OECD Corporate Governance Committee asked several corporate and business leaders for their advice in implementing the Principles from the boardroom perspective (OECD 2008). Some of their recommendations addressed board formation and are listed below:

- "Building an effective board takes time and patience on the part of board members, but especially on the part of their chairs. It is the chair's task to weld a group of capable individuals into an effective board team. The nominations process could require nominees to prepare a statement explaining why they will add value to the board" (Sir Adrian Cadbury).[4]

- "Building a good board should be the work of the board, not the CEO. However, at many companies, the independent nominating committee treats the CEO as a partner in the director selection process, by involving the CEO in interviews and asking for his or her opinion about the suitability of potential directors" (Jack Krol).[5]

- "Companies in developing countries should observe best practices if they want to be competitive internationally. To that end, they should seek directors who are committed to improving the system and who can push for the changes that may be required to enhance the company's competitiveness in international markets – they should be people of integrity who are willing to make a difference. Companies can determine whether a person may be suitable by looking at his or her track record and reputation in the business community" (Jesus Estanislao).[6]

- "Before joining a board, directors should ask two questions: first, why they are being asked to join that particular board and second, whether the board opportunity is real or just 'window-dressing.' Potential directors should ascertain whether they are being asked to join the board for diversity reasons, to satisfy regulatory requirements or because of their skills, experience and judgement. In addition, directors should satisfy themselves about the role of the board and whether its input is valued at the company, especially at controlled or family companies.

  Boards often resemble families with each person appearing to have a particular role. Some boards also have director 'cliques.' Upon joining a board, directors should think about their role on the

board and where they fit. New directors should work to establish themselves by leading with their unique skills. For example, a director with a strategic background could ask questions about how well the company analyses what its competitors are doing and how it's operating structure compares to theirs. It can be difficult for new directors – particularly those in the minority – to find their voice on a board. New directors should strive to bring a different perspective to build credibility and avoid 'add-on' comments. Directors may need to work extra hard to make their mark and avoid exclusion from debates on issues that do not directly relate to their minority status" (Michele Hooper).[7]

- "Before joining a board, directors should ensure that they understand the ownership and control structure of the company and seek information where the ultimate ownership is unclear. If the company is not forthcoming with this information, the director should refuse to join the board" (Dr. N. Balasubramanian).[8]

1.2.3. SOEs experiences

44. Within its work with SOEs, the OECD Working Party on State Ownership and Privatisation Practices published in 2012 a stocktaking report on the functioning of SOE boards (OECD 2012 b). It outlines some of the key elements of a robust board nomination policy framework, including: i) specifying the person or body responsible for nominating the board member; ii) being transparent about any qualifications that may be required or guidelines that exist on appointments; and iii) pursuing a consistent approach across all SOEs.

45. Nominating procedures vary across countries, but in the majority of jurisdictions, as the report concludes, the relevant Ministry is exercising the right of nomination. In more centralised systems, the Treasurer or Finance Minister is often vested with the nomination power, or the nomination power may be split between the sectoral Minister and the Treasurer. It is also common in OECD countries that the nomination decision of a Minister is subject to some form of veto by a wider group of Ministers, the Cabinet or Head of State (as in Sweden, for example).

46. Some SOEs have board nominations committees operating much like private sector enterprises while in others they report to the AGM, which is the body that nominates the board members. This is the case of Norway, for instance, where the nomination committee is composed of three independent members and one government representative and reports to the AGM of the SOEs.

47. In some jurisdictions, the role of nomination has been handed to an independent body that either appoints nominees or recommends them to the government. The report explains that the use of external advisors expands the search base of candidates and applies professional techniques that stands in contrast to the often informal practices used to characterised board nominations. This practice is in line with the Guidelines and promotes depoliticizing of the board appointment process.

48. The report describes the measures that Governments take to improve the way nominations to boards are conducted. It shows that some jurisdictions have adopted gatekeeper arrangements to provide a clearinghouse for applications, enabling applicants to be considered from a wide variety of sources but nevertheless subject to a uniform assessment process. Where a centralised ownership unit has been established, it is common for the unit to have responsibility for soliciting/receiving applications and then vetting these applications against any pre-determined qualification criteria.

49. When it comes to defining the desired qualifications for candidates to serve on an SOE board, about half of the jurisdictions surveyed by the report have established clear criteria, such as years of education and quantifiable experience requirements (Poland, Israel and Greece are some examples). The other half uses qualitative characteristics and more holistic descriptions to member qualities focusing on the outcomes required (e.g. Sweden). The advantage of this approach is that it

more flexibly accommodates board members whose profile might not meet standard criteria, but who may nevertheless add value to the board.

50. New Zealand uses gap analyses of the board to select candidates. After the gap analysis is conducted, potential nominees are examined and a short list is developed and presented to ministers. Chile, for example, has the ownership unit drawing nominations from a wide variety of sources; Slovenia has established an Accreditation Committee to manage all stages of identifying potential candidates; and Portugal has taken a similar approach. Finland is reported to be outsourcing the development and maintenance of the pre-qualified database of candidates to a recruitment consulting firm. The use of recruitment consultants is relatively wide spread and several jurisdictions have noted that they outsourced services, particularly for Chair appointments, where an SOE was particularly large or where an SOE was facing particular challenges.

51. In terms of constraints in appointing candidates for board members, OECD jurisdictions are commonly concerned by promoting independence and ensuring proper handling of potential conflicts of interest. Independence is often meant from both the management of the SOE and from business relationships of the SOE. The report highlights that OECD jurisdictions screen candidates for conflicts by either having an express vetting process, by excluding particular classes of applicants who may have conflict of interest, or by a combination of both methods. Many jurisdictions ban serving politicians and civil servants from appointments. New Zealand, for instance, has an absolute ban on any serving politicians or civil servants for sitting on SOE boards. Finland, which actively uses civil servant representatives, resolves the potential conflict of interest by forbidding high-ranking civil servants to serve on boards.

52. The report also examined the number of appointments that a candidate could simultaneously hold. In Austria, for instance, the maximum number of appointments was 10, while in Greece only one appointment was allowed (or was allowed to be remunerated). Five other jurisdictions have introduced hard limits, while countries without formal limits still take this issue in consideration in identifying suitable candidates.

53. Gender issues are also considered in a number of countries. Austria, Sweden and Finland are examples of introducing hard quotas (a minimum quota of 25% of female representation by the end 2013 in Austria and a minimum requirement of 40% in Finland and Sweden). Israel and New Zealand promote gender diversity by less constraining means.

54. As to the role of the board itself in nomination process, the formal involvement of the board and the existence of nomination committees are rare in unlisted SOEs and common in listed SOEs. Removing the nomination decision from the board appears to insulate the process from a potential moral hazard. Board members protect themselves from scrutiny by nominating friends like-minded individuals.

55. Non-Government shareholders' participation in the election is promoted by the Guidelines and the report identifies three separate sets of mechanisms that facilitate non-Government shareholders electing representatives. Firstly, the relevant company laws often provide a voting framework or protections to ensure adequate representation of shareholders. AGM voting process in surveyed countries generally allow non-governmental shareholder to participate in the voting process. In Slovenia and Poland the voting procedures at the AGM provide an opportunity to informal discussions amongst shareholders to attempt obtaining consensus on board appointments.

56. Secondly, SOE by-laws also often contain voting procedures that enshrine the rights of the various shareholders and promote coordination. It Italy, the by-laws of some non-listed SOEs require "listing vote systems", a form of cumulative voting that ensures that minority shareholders are always

represented in the board. In Brazil the SOE by-laws also guarantee representation for shareholders holding greater than 15% of the voting stock.

57. Finally, some countries (like Denmark, Finland, and Sweden) also use shareholder agreements to guarantee the appointment of a certain number of non-governmental shareholder representatives. This is particularly relevant in SOEs where besides government there are minority shareholders representing an industry partner or important investor.

58. In a related working paper, published in 2011, the OECD Working Party on State Ownership and Privatisation Practices also elaborated on possible recommendations for improving the nomination process of SOE boards (Frederick, 2011). The report stresses that the ideal approach to board formation is to appoint based on merit, and retain based on performance.

59. The key issue in board nomination is the proclivity for politicisation. The report argues that it has the following negative effects: change of the board with a change in political powers; excessive or insufficient turnover of board members; friend appointments and patronage; changing members without good reason; and the inability to obtain desired profiles. Another practical problem outlined by the report is delays in government decision making. When politicisation occurs, it may jeopardise board formation and hamper the efficiency of the SOE.

60. The report notes that there is always a political overlay to SOE board member nominations, because ministers want to have board members who share their thinking. The challenge is to not politicise excessively and to shield the process from politicisation by ensuring that needed profiles are elected to the board. For this, there must be a formal process, without exceptions or ad hoc changes, and that the nominations must be publicly transparent, placing the procedures under public scrutiny.

II. BOARD FORMATION IN RUSSIA

61. The formation of boards of directors and their functioning is one of the most relevant issues of the current corporate governance debate in the Russian Federation. The following sections aim to describe and assess the rules and practices in Russia against the background offered by the OECD standards and practices reviewed in the previous chapter.

2.1. The Russian corporate governance framework

62. The corporate governance framework and practices of the Russian Federation are not more than a couple of decades old. They were created within several privatization waves that changed the Soviet property system into what the Russian government hoped would be a dispersed shareholder capitalism that would help promote a robust market economy. In fact, as in many other countries, novice shareholders were quick to trade their shares for cash, and ownership became concentrated in the hands of a few powerful insiders. These former managers prospered and their success opened up opportunities for raiding in the corporate sphere. The need to respond to this evolving situation as well

the concerns regarding the protection of the minority shareholders' and portfolio investors' rights defined the development of the legal framework. It has improved significantly in recent years, although prominent loopholes remain and enforcement is still weak.

63. The Russian equity market is concentrated in the ten largest companies (MICEX 10 Index) and in natural resources. The oil and gas sector accounts for 55% of market capitalization, followed by the metals and mining sector with a 13% share. The same two sectors account for roughly the same share of the total stock turnover on the Moscow exchange. The ownership structure of public companies remains concentrated, with small free float. The 10 most capitalized and most traded domestic equities account for about 90% of the domestic free float (free float weighted capitalization) and roughly the same share of the total daily equity turnover.

64. Business groups, many of which include banks and often involve opaque ownership structures or complex cross holdings, combined with an ineffective framework for determining related parties and affiliates, exacerbate risks of abuse. The process of forming controlling shareholders has often been opaque, but even where they exist, some 30 per cent of companies report that other significant block holders remain. The history of the past twenty years is marked by corporate disputes among controlling shareholders and block holders, between controlling and portfolio investors, as well as attempts by the regulators to impose better corporate governance practices. This has meant a significant challenge for the development of the Russian capital market, reflected in part in the low free float ratios in most Russian listed companies, as well as in the discounted price-to-earnings ratios of Russian shares in comparison to those of other BRIC countries.

65. The Russian State is a prominent controlling shareholder, including in listed companies. Studies show that the extent of State control is higher in Russia than in any OECD country and that many of the largest listed companies are majority owned by the State. The government has been committed to concentrate State control in sectors of the economy identified as "strategic" by the acquisition of assets and, at times, the controversial takeover of companies. This has led to the creation of large State-owned or controlled conglomerates and to the promotion of "national champions."

66. A still complex ownership structure reduces transparency and accountability of the SOE sector, but privatisation is again on the public policy agenda. The authorities have made several calls for decisive action (such as the recent secondary public offering of 7% of the shares in Sberbank),[9] but the real extent to which the size of the SOE sector will be reduced is difficult to assess for now.

67. In general, investors perceive that the corporate governance framework is improving. There is an appropriately focused modernisation agenda, where the authorities have correctly identified the most pressing challenges and already passed a number of laws and regulations or submitted bills to address them. Positive developments include the recently approved insider trading law and the framework for introducing IFRS. However, investors are now looking forward to see how the laws will be enforced, and still worry how insufficiently developed institutions and corruption may put the rule of law to the test. The Russian authorities themselves recognize the need for decisive action, especially now that there is the ambition to establish Moscow as a leading financial centre.

68. The legal and regulatory framework for board nomination in Russia is provided essentially by the Law "On Joint Stock Companies" (hereafter "JSC Law") and the Code of Corporate Conduct.

69. The JSC Law was adopted in 1995 and amended in 1996, 1999 and every year since 2001. It is the principal piece of legislation regulating the activities of companies in Russia. It outlines key governance arrangements for both listed and unlisted companies, but leaves a number of essential governance questions to be specified in the charter of each entity (Box 2).

Box 2. Essential Board Rules in the JSC Law

Members of the board of directors of a company are elected by the general meeting according to a procedure envisaged by article 66 of the JSC Law for a term till the next annual general meeting. Shareholders with more than two per cent of voting shares are entitled to nominate persons to be board members (article 53). They are elected each year at the AGM using cumulative voting. Directors may be re-elected indefinitely.

The number or board members in the board is determined by the articles of the company or by a general meeting decision, but it cannot be less than five. In the case of companies with more than 1.000 shareholders with voting shares, the minimum is raised to seven members, and to nine members in the case of companies with more than 10,000 shareholders.

Pursuant to article 66 of the JSC Law, executive board members can hold no more than 25% of the total seats in the board. At the same time a person exercising the functions of a one-man executive body cannot be at the same time the chairperson of the board of the company. The general meeting may early terminate the powers of all the members of the board of directors. Shareholders holding at least 10% of the company's voting shares can require the board to call an extraordinary general meeting of shareholders.

Pursuant to the JSC Law, the board is in charge of general management of the company and is accountable to the general shareholder meeting, the supreme governing body of a joint-stock company. The matters assigned to the competence of the board are: (i) defining priority guidelines for the company; (ii) calling annual and extraordinary general meetings; (iii) approving the agenda of a general shareholder meeting; (iv) defining the date for compiling a list of persons entitled to take part in general shareholder meetings; (v) increasing the authorized capital of the company through the placement of additional shares (if this competence is given to the board by the respective issues' charter in accordance with the JSC Law); (vi) placement by the company of bonds and other equity securities; (vii) determining the price (monetary value) of property as well as the placing and repurchase prices of equity securities; (viii) purchasing shares, bonds and other securities that have been placed by the company; (ix) formation of the company's governing body and early termination of its powers (if provided by respective issues' charter); (x) recommendations on the size of the remuneration and compensations payable to the members of the Audit Commission (internal auditor) of the company as well as the auditor's fee; (xi) recommendations on the size of the share dividend and its payment procedure; (xii) utilization of the Reserve Fund and other funds of the company; (xiii) endorsing internal documents of the company; (xiv) establishing branches and opening representative offices of the company; (xv) approving large transactions as defined in chapter X of the JSC Law[10]; (xvi) approving certain related parties transactions as defined in chapter XI of the JSC Law[11]; (xvii) confirmation of the company's registrar; (xviii) decision making on the company's participation in, and withdrawal from, other organizations; and (xix) other matters that the law or company articles refer to the competence of the board of directors.

Source: JSC Law; OECD

70. The Code of Corporate Conduct (or Corporate Governance Code) was introduced by the securities regulator (at present the Federal Financial Market Service, hereinafter "the FFMS") in 2002 as an instrument intended to help companies improve their governance processes and practices on a voluntary basis. The Code is recommended by the FFMS to all joint stock companies. In practice, however, as the Code has been developed primarily for JSCs seeking access to the capital market, only public companies are concerned (Box 3).

71. Certain provisions of the Code have been subsequently incorporated into the legislation as imperative norms, such as the rules related to information disclosure by public corporations, possibility of absentee voting, etc. Other rules have been adopted as part of the listing requirements on the stock exchange, mostly for top-tier listed companies only.[12] But even for top tiers of the stock exchange, the Code does not apply in its entirety. When companies do not comply they are encouraged to disclose this fact (without necessarily providing further explanations). The Moscow exchange is charged with the responsibility for monitoring companies' compliance with the Code's recommendations.

72. The Corporate Governance Code has been criticized on certain points, notably regarding the lack of precision in the rules on director independence. Likewise, some of the provisions of the Code are claimed not to be sufficiently calibrated for companies with single and dual tier board structures,

both of which are allowed in Russia.[13] Furthermore, a 2006 report by S&P noted that "rather than complementing existing corporate legislation, in some places, the Code and the corporate legislation are in conflict" (S&P 2006).

Box 3. Excerpts from the Corporate Governance Code

2.1. Composition of the board of directors should optimize the effectiveness of the board of directors: 1) The board of directors should enjoy the trust of shareholders – otherwise it will not be able effectively to perform its functions. The personal qualities of members of the board of directors and their reputation should not give rise to any doubts that they may not act in the best interests of the company; therefore, it is recommended that only persons with impeccable reputations be elected as members of the board of directors; 2) It is not advisable to elect to the board of directors a person who is a member of the board of directors, the director general, a member of a management body or an employee of a competitor of the company; 3) It is advisable that the charter of the company explicitly sets forth specific criteria for members of the board of directors.

2.2. It is recommended that the board of directors should include independent directors: 1) As a rule, boards of directors of Russian companies consist of three categories of directors – executive, non-executive and independent directors; 2) Independent directors ensure that the board of directors forms an objective opinion on matters under discussion, which ultimately increases investor confidence in the company; 3) It is recommended that the company's charter should provide that the board of directors include at least three independent directors; 4) Independent directors should refrain from actions that may compromise their independent status; 5) It is advisable that information about independent directors is disclosed in the annual report of the company.

2.3. It is recommended that election of the board of directors be conducted in accordance with a transparent procedure that takes into account the diverse opinions held by shareholders, ensures that the composition of the board of directors is in compliance with statutory requirements, and allows the election of independent directors: 1) It is recommended that shareholders be provided with the following information: the identity of the person proposed the relevant candidate: age, education of the candidate, positions held over the last five years, position held at the moment of nomination, nature of relations with the company, membership in the boards of directors or official positions held with other legal persons, as well as nominations for membership in the boards of directors or nominations for election (appointment) to official positions with other legal persons, information on relations with affiliated persons, the nature of relations with major business partners of the company, as well as other information related to the financial status of the candidate or which may otherwise affect the discharge by the person of the duties of a member of the board of directors of the company; 2) In an election of members of the board of directors, opinions of all shareholders should be taken into account, including those with small share holdings. This goal may be achieved only by electing members of the board of directors by cumulative voting, which should be stipulated in the charter whether or not such a requirement is set forth in law; 3) The law restricts the participation of the director general or members of the managerial board of the company in the board of directors.

Source: Corporate Governance Code, Chapter 3, Section 2, Composition and Election of the Board of Directors.

73. The FFMS has plans to issue a revised version of the Corporate Governance Code with the purpose of eliminating recommendations already regulated by the legal framework, introducing greater precision in certain provisions, and overall bringing the Code closer to the best international practice. However, the announced merger of the FFMS into the Central Bank[14] may delay these update efforts. In parallel, the Moscow Exchange has been developing a similar work in preparation of revised listing requirements that may include a premium listing segment, subject to these higher corporate governance requirements.

2.1.1. Board nomination processes and shareholders' rights

74. As described when reviewing the results of the OECD peer review (OECD 2012a), the Russian ownership structure is important in determining the process for nomination and election of the board. Ownership concentration in Russia is very high, with dispersed shareholding being the exception rather than the norm, although its precise extent is difficult to estimate because of

insufficiently strong beneficial ownership reporting requirements and weak transparency of listed companies.

75. Standard & Poor's research (S&P, 2011) on the 90 largest public companies shows that 54 are majority owned, and another 24 companies have one or more blocking shareholders (holding over 25% of votes). Only 12 companies have widely dispersed ownership. However, even in these cases, it is assumed that hidden groups of holdings and shareholder agreements are likely to exist, allowing for more influence than would otherwise appear.

76. In 2003, 60% of the Russian stock market capitalization was owned by the top ten families (Enikolopov and Stepanov, 2012), well ahead of continental Europe and higher than in most East Asian countries prior to the 1997 crisis (Guriev and Rachinsky, 2005). Some studies argue that concentrated ownership and large business groups was a natural response in Russia to multiple market and government failures (Khanna and Yafen, 2007). The ability of large businesses to protect their property rights against both the private sector and government intervention resided precisely in their size, giving them an advantage that smaller competitors did not have. Likewise, the size of these conglomerates allowed them to finance themselves more easily and redistribute the cash flows intra-group in the face of an underdeveloped external capital market. Internal mobility of the workforce was also a substitute for an inefficient labor market (Shumilov and Volchkova, 2004).

77. This high concentration of ownership in the hands of a few powerful shareholders presents challenges similar to those described from Indonesia and Korea in the OECD peer review, rather than those faced by countries like the U.S. or the Netherlands. This is somehow reflected in strong *de jure* duties assigned to the board (Box 2) combined with a *de facto* situation in which they often do not play a decisive role in the governance of the company. Perhaps for this reason the nature of the Russian board of directors has been described as falling between the models of the German supervisory board, and the U.S. board including managers, "but fails to fulfill either function adequately" (OECD, 2006).

78. A more objective description of the average Russian board may be that of a single-tier board, where management is limited to 25 per cent of the seats and where the CEO cannot hold the chairman's position. Pursuant to Russian law, a board of directors must be composed of at least five members, all elected for one-year terms. Directors' mandates can be terminated at any point or extended indefinitely (by periods of no more than one year)[15] by the AGM.

79. According to the survey of board members conducted by PwC and the Independent Director Association for the OECD Russia Corporate Governance Roundtable (PwC, 2012 b), the average Russian company has 10 members in its board (80% of the companies in the sample have 7 to 11 directors).). The minimum size of boards in the reviewed companies is 5 people (in line with the JSC Law required minimum) and the maximum is18. The survey also describes that in 90% of the top 50 Russian public companies the corporate charter sets limits on the number of board members, with two-thirds setting the exact number.

80. There are no legal requirements regarding board committees in Russia. The Russian Corporate Governance Code, in turn, recommends that companies should determine the number of committees they create. The PwC and IDA survey of board members shows that two out of three companies in their sample have a nomination committee or equivalent body (often integrated with the functions of a remunerations committee), with 4 members on average and two of them being independent directors (with between two and three on average among listed companies). In 70% of the top 50 Russian public companies the chairman of the nomination committee is an independent director (PwC, 2012 b).

81. Unlike in other countries, however, in Russia the board and its nomination committee are not allowed to make additional nominations to those of the shareholders. Only if shareholders fail to nominate enough candidates to fill all seats, the board is allowed to complement. Some practitioners in Russia argue that this subsidiary role of the board in nominating candidates has caused boards and their nomination committees to have no influence in recruiting independent and professional board members.

82. In a KPMG survey of Russian companies (KPMG, 2011), the (then) Executive Director of the Independent Directors Association, Alexander Filatov, highlighted the importance of endowing boards with the power to nominate board members in order to improve corporate governance in Russia overall. When only shareholders can nominate board members, he argued, the boards are very loyal and serve only the interests of those shareholders who nominated them.

83. This may however change, as there are initiatives to make the nomination procedure and the selection criteria for nominations more effective and transparent. This is on the agenda of the authorities and an issue identified for inclusion in the future update of the Corporate Governance Code, with one proposal requiring that any candidates proposed by the board should meet the independence requirements. The International Financial Centre (IFC) Working Group has also recommended adopting a provision that entitles the board of directors to nominate candidates to be elected as independent directors, even in case when shareholders submit enough candidates.

84. When offering an overall assessment of Russian board practices for the NCCG annual report, based on three relatively recent research studies, Sergei Guriev suggests that boards of Russian companies are still in transition. Partly due to the ongoing evolution of their ownership structure, many companies have not created strong boards and boards committees, and independent directors perceive their role as more of an advisor than a steward of the company.

85. The study conducted by KPMG showed that board of directors' most important task in Russia is typically taking strategic decisions about business development, followed by work related to financial issues (deciding the financial policy, internal control, audit, and remuneration of the top management). About 70% of the 81 companies with board of directors in the sample report having independent directors on their boards, and describe their key function as working on strengthening confidence to the company among shareholders and investors, followed by advising top management and to control the reliability of financial reporting (KPMG, 2011).

86. In terms of gender balance, the PwC and IDA survey on board formation shows that in 2012 only 11% of board members are females. On the boards of the top 50 Russian public companies the percentage is reduced to 7%, with a maximum 3 females on each board. None of those companies has a female chairperson (PwC, 2012 b).

87. Many Russian companies have dual listing as a result of their search for foreign capital via offshore listings, mostly on the New York, Hong Kong and London stock exchanges.[16] Besides helping to raise governance practices in line with standards required by those foreign stock exchanges, this has caused a surge in the number of foreigners accepting board positions in Russian listed companies. With their experience, they are said to have lifted the standards and practices of many of those boards.[17] An example of such international structure may be the board of Rusal, the world's largest aluminum producer,[18] where five out of its 18 board members are foreigners.

88. A recent survey of corporate secretaries conducted by the Deloitte Center for Corporate Governance and the National Union for Corporate Secretaries[19] discovered unusual board meeting patterns (Deloitte, 2012). On the one hand, 1 out of every 4 boards have two or less meetings in person per year (one out of five in the case of public companies), and 11% of the boards (5% for public companies) actually never meet in person. On the other hand, in about 10% of the companies included

in the sample the board meets in person even more often than once a month. The report suggests that both extremes may be signs of ineffective board functioning.

89. Guriev outlines some of the trends among Russian board by describing some key elements of their functioning. First, he points out the limited fiduciary and reputational incentives of board members spurred by the weak enforcement of corporate law in Russia. He argues that the Russian judicial system lacks more independence and competence on corporate governance. Second, he claims that there is a shortage of qualified board members in Russia. Comparing with the situation in the U.S., he points out that due to the short life of the Russian market economy, there is not an abundant offer of qualified candidates. There are not many retired CEOs or entrepreneurs; not too many good business schools from where to select professors; government officials have low turnover; and the participation of foreigners is rather an exception considering the language challenge and the necessity to know the local business culture. Finally, he says that the demand for independent directors is not as great as it might seem:

> "Most private companies still have a controlling shareholder who owns a vertically or horizontally integrated group of companies. In these cases, a representative of the group in the board of directors cannot be, by definition, an independent director taking care of any particular company. State-owned companies come across similar problems: the officials who nominate board members in these companies are normally responsible for a wide range of economic policy issues and, thus, they often have a conflict of interests with respect to each company." (Guriev, 2012, p. 179)

90. A survey of board directors conducted by PwC in 2012 shows that over 60% of its respondents also consider that there is a shortage of qualified directors (PwC, 2012 a). They comment that many boards in Russia do not set an objective to seek directors with specific knowledge, experience and skills. Those companies that set this objective have encountered difficulties in finding candidates with the skills and experience in the area of risk management (48%), with experience in international companies (35%), in marketing (29%) and even in finance (23%).

91. This was also highlighted by the recent Deloitte survey that describes "a shortage of competent, independent directors with strong personal integrity" being listed by 47% of respondents among the main impediments for improving corporate governance at their companies. A lack of a tradition of corporate governance and weaknesses in the Russian law were the other two reasons named the most.

92. The shortage of competent directors explains perhaps another negative trend in the development of the board membership practices mentioned in the 2011 report of the Russian Institute of Directors (hereafter "RID"). The report demonstrates an increase in the share of companies in which board members are also members of the boards of directors of more than five other companies (51% of the overall sample, 63% of listed companies and 63% of SOEs). And in 2010 a swift further growth of this share was observed for all groups of companies.

2.1.2. Shareholders' right to elect board members

93. The JSC Law prescribes that shareholders holding at less 2% of the voting shares of the company are entitled to propose items for the agenda of the AGM and to nominate candidates to the board of directors. The number of candidates cannot exceed the number of members of the board. Shareholders should make their proposals in writing, specifying the names of the shareholders and the number and type of shares they hold, and should be received by the company no later than 30 days after the end of the financial year, unless the company's charter sets a later date.

94. These provisions are generally in line with OECD Principle II.A that stipulates that a basic shareholder right includes the right to elect and remove members of the board and the threshold of 2% is within the average for countries requiring them. However, in his study of Russian boards, Guriev argues that it may be quite difficult to obtain 2% of voting shares in large companies such as Gazprom, Sberbank, Rosneft or VTB (Guriev, 2012). On the other hand, he also mentions that as soon as shareholders are able to meet the threshold to nominate a worthy candidate, particularly when supported by proxy advisors, a majority of shareholders will support the nomination.

95. Election of the board of directors must be on the agenda of the AGM, as well as the approval of the company's independent auditor and internal audit commission. The meeting must be convened by the board of directors, which is also required to review the candidates' proposals and decide on their inclusion to the agenda not later than 5 days after the expiration of the relevant deadlines.[20] As mentioned, current legislation entitles the board of directors to include its own candidates only in the absence of sufficient candidates proposed by shareholders.

96. Voting at general meetings is based on the principle of one-share-one-vote, but for board elections the law prescribes cumulative voting. Pursuant to it, each shareholder may cast an aggregate number of votes equal to the number of voting shares held by such shareholder multiplied by the number of persons to be elected to the board of directors, and the shareholder may give all her votes to one candidate or spread them between two or more candidates.

97. Board members are elected for one-year terms at the AGM and may be re-elected indefinitely. The AGM may also decide to replace the board before the end of their term, at any time and without cause, by a simple majority vote. The Russian proxy system is based on the formal use of powers of attorney but nevertheless allow a shareholder to vote represented by others. Votes by ballots posted through the mail are said to be often used and to function adequately.[21] Voting ballots are sent by registered letter, unless the company's charter provides for a different method. Both are in line with the OECD Principles and ensure the shareholder's right to vote in absentia, and that votes casted in person and in absentia are given equal effect.

98. According to the PwC and IDA survey, only in one quarter of companies in their sample shareholders are involved in the selection of candidates for the board. In 63% of them the board or the nominations committee participates in the process and in 15% of companies (mostly listed companies) there is the involvement of external consultants. About a third of the board members surveyed claim that minority shareholders generally nominate candidates to the board, but in 46% of the cases it is reported "that generally minorities are not active in nominating directors" and in one third of the companies surveyed, minority shareholders generally do not nominate directors (PwC, 2012 b).

99. In his study of board of directors in Russia, Guriev notes that recently the efficiency of board elections has improved substantially through the work of proxy advisors (Guriev 2012). In fact, proxy advisors act as a rating agency for the board of directors, assessing the quality of corporate governance practices in a corporation and the advantages and reputation of individual candidates for its board. The recommendations on which directors to elect that proxy advisors give shareholders are said to be followed by the overwhelming majority of institutional investors.

100. Although shareholder activism is not developed in Russia, some group and individual efforts are visible (Enikolopov and Stepanov, 2012). The Investor Protection Association (IPA), for instance, coordinates minority shareholders' actions and helps them with information and legal advice. Despite being a small organization with about 25 members, mostly foreign funds, the IPA members coordinated the election of 34 directors in 23 companies in 2011[22] and in 2012 independent directors were nominated to 84 issuers.[23] However, as Enikolopov and Stepanov describe, in the face of large controlling shareholder, Russian activists' best hope is to elect a single or maybe two directors in the

board, which lacks sufficient power to promote change. Furthermore, they argue that the threat of litigation is not regarded as credible due weak enforcement of the rule of law.

101. The FFMS has proposed amendments to the JSC Law to allow individual companies to decide whether they want to introduce in their charter a requirement for a minimum number of independent directors to the board. If a company decides to introduce such requirement then they would also have to include a list of criteria to be met by an independent director. Even though diversity and gender representation on the board often are mentioned in public debates, there are no known initiatives to turn them into legal or regulatory requirements.

2.1.3. Degree of disclosure about the nomination and election process

102. Shareholders entitled to participate in the AGM where the board is to be elected should be provided with information about the candidates to the board in accordance with the JSC Law, which are rather scarce. Article 53 of the JSC Law prescribes that "a proposal concerning nominees state the name of each nominee and data of the document certifying his identity, the name of the body to which he/she is proposed for election and also other information on him/her as stipulated by the charter or in-house documents of the company." The FFMS regulations require additionally that participants of the AGM where a board election is to be conducted to be provided with information on whether the board candidate has given his/her written agreement to be elected to the respective board.

103. In turn, the Corporate Governance Code further states[24] that shareholders should have an opportunity to receive full information about all candidates to the board, and lists the main elements, including the identity of the candidate and her/his:

- Age;
- Education;
- Positions held over the last five years;
- Position held at the moment of nomination;
- Nature of relations with the company;
- Membership in the boards of directors or official positions held with other legal persons, as well as nomination for membership in the boards of directors or nomination for election (appointment) to official positions with other legal persons;
- Relations with affiliated persons;
- Relations with major business partners of the company; and
- Additional information related to the financial status of the candidate or which may otherwise affect the discharge by the person of the duties of a member of the board of directors of the company.

104. According to the results of the PwC and IDA survey (PwC, 2012 b), only half of the top 50 Russian public companies disclose background information on board candidates and when they do, it is "limited and usually contains data on nominees' current jobs and directorships, education and professional competence, previous jobs and directorships over the last few years and age" (PwC, 2012 b, p. 22). Furthermore, "none of the companies publishes information about nomination for other jobs and directorships, the nature of relations with the company or its major business partners that could lead to conflicts of interest and affect a board's judgment" (Ibid).

105. As it was mentioned in the previous chapter, the OECD Principles require boards to ensure a "formal and transparent board nomination and election process". The Corporate Governance Code recommends that the election of the board should be conducted in accordance with "a transparent procedure that takes into account the diverse opinions held by shareholders, ensures that the composition of the board of directors is in compliance with statutory requirements, and allows the election of independent directors."[25]

106. The Results of the PwC and IDA 2012 survey conducted for the Roundtable show that procedures for board elections are formalized in about two thirds of companies, with 21% of those being regarded as "properly formalized" as well as "overall transparent", and 42% of them regarded as "formalized and quite transparent". As an example, in 19% of companies there are formal limitations in place for the number of other board positions a candidate can hold (PwC, 2012 b).

107. According to the recent Deloitte survey of corporate secretaries (Deloitte, 2012) only a third of the boards (46% in the case of listed companies) perform annual evaluations and only 2% (5% for listed companies) go beyond self-assessment and engage external consultants every few years.

108. The results of the PwC and IDA survey show better results on their sample, with about two thirds of boards (70% among listed companies) conducting annual performance evaluations, while 22% never conduct such evaluations. The survey notes that in the case of SOEs "this rate is almost twice as high and makes up 42% of companies" (PwC, 2012 b, p. 35). Those evaluations are mostly self-assessments conducted through questionnaires, but 34% of boards use KPIs and a further 20% (mostly listed companies) conduct externally facilitated board evaluations. These evaluations are disclosed in the company's website in about 10% of the cases, as well as in their annual reports (43%) or they are presented to the AGM (34%). In one third of companies there is no disclosure about this at all.

109. Further efforts from both the State and the companies are needed to make the board nomination and election procedures more transparent and ensure full disclosure about the qualifications of nominated board members.

2.1.4. Overall functioning

110. A well functioning nomination and election framework should render boards that are competent and committed to perform the functions that investors, regulators and stakeholders assign to them. The OECD Principles indentify some of those functions as key, including selecting, compensating and, when necessary, replacing key executives and overseeing succession planning. Also, to review and guide corporate strategy, major plans of action, risk policy, annual budgets and business plans, as well as to set performance objectives, monitor implementation and corporate performance, and overseeing major capital expenditures, acquisitions and divestitures.

111. Despite the fact that there is widespread acknowledgment that board practices have significantly improved in recent years, there is evidence that in many Russian companies the most important decisions are still adopted outside of the board room. This is also related to a common claim of a lack of independent leadership by Chairmen, who are often viewed as too aligned with the CEO.

112. In the highly concentrated ownership structure of most Russian listed companies, there is a great deal of evidence pointing to control of decisions related to strategy and appointing management at the controlling shareholder level. According to the PwC survey, Russian boards are most efficient in ensuring the fairness of the financial statements and in their ability to make a critical assessment of senior management performance (PwC 2012 b). Setting an adequate structure and level for senior management remuneration and developing succession plans are areas where they perform less efficiently (Table 1).

113. In 2012 the respondents of a PwC's Survey were asked to rank functions or duties in the area of control and supervision of company activities according to their importance, and to name those that they would like to focus on during the upcoming year. Risk management topped the priority list (26% of the respondents say they would like their board of directors to give that issue much more attention than in prior periods). Strategic planning landed in second place. Top management remuneration, personnel development and continuity planning are also high on the list of priorities (PwC, 2012 a).

114. Practitioners often argue that corporate secretaries, the person who handles the agendas and the documents of the board (but is not a board member), are too often selected by the largest shareholders and exercise a strong influence on the operation of the board, sometimes in a way which accommodates the interest of those shareholders.[26] The RID study (RID, 2011) showed that 40% of the reviewed companies have a position of corporate secretary (among listed companies this figure amounts to 52% and only 14% of SOEs have this position). In the past years a decreasing trend in the share of the companies having secretary position has been observed.

Table 1. Boards' effectiveness survey

How would you estimate the effectiveness of your board on each of the following dimensions?					
	Very efficient to ineficient				
	1	2	3	4	5
Ability of the audit committee to ensure the fairness of the financial statements	26%	42%	16%	6%	10%
Board of directors' ability to make a critical assessment of the general director / CEO performance and challenge him / her, if necessary	23%	23%	32%	13%	10%
Ability of the HR / appointments committee to appoint a board of directors whose members demonstrate a balanced combination of requisite knowledge, skills and work experience	19%	32%	26%	10%	13%
Ability of the board of directors to evaluate the general director / CEO efficiency	13%	32%	26%	19%	10%
Ability of the board of directors to evaluate how risk management plans are being executed	3%	39%	35%	19%	3%
Ability of the remunerations committee to establish and adequate structure and level for the general director / CEO remuneration	6%	29%	35%	19%	10%
Ability of the board of directors to prepare a general director / CEO continuity plan	6%	23%	39%	16%	16%

Source: PWC, 2012 a.

115. The Deloitte 2012 survey shows that corporate secretaries (detached from an executive role) are present in about half the companies within the sample but only have staff and a budget for performing their functions at 22% of companies (30% of public companies), suggesting that they "often lack the resources needed to perform their duties adequately" and also that they often "lack support in their efforts to improve corporate governance" (Deloitte, 2012, p.2).

116. In their recent assessment of corporate governance in Russia, Enikolopov and Stepanov highlight that reputation is the key mechanism of corporate governance in the weak legal environment they describe in Russia. This entails that the challenge is not only that of adopting formally best corporate governance norms, but also of constantly following them and thus building credibility. However, they also point out how that credibility of self-imposed constraints is lower since controlling shareholders can lift these self-restrains whenever they decide, and investors know that (Enikolopov and Stepanov, 2012).

117. A strong and sufficiently independent board may act as guarantor, at least to a certain extent, of a company´s commitment to sound corporate governance, thereby increasing investors' confidence.

2.2. The rules and practices in the SOE sector

118. According the OECD Product Market Regulation Indicators, a comparable set of country measurements elaborated by the Organization, the extent of State control in Russia is higher than in any OECD country (OECD, 2011).

119. Research by S&P and the New Economic School (S&P, 2010) shows that as of 2010, 30 out of 90 largest companies were majority owned by the State, directly or through intermediaries (Table 2). Since government-controlled companies tend to be the largest, their market value represented more than half of the value of market capitalization of the largest 90 companies.

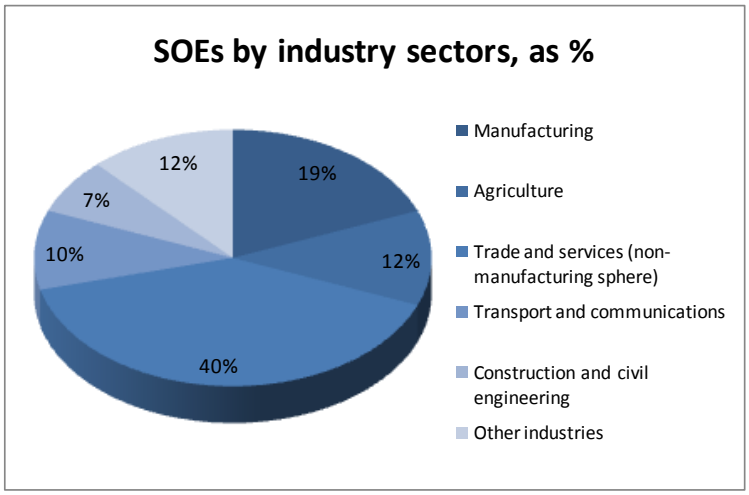
Table 2. State's share is largest Russian companies, 2010

Concentration of Ownership, 90 Largest Russian Companies, 2010				
	Number of Companies	Companies in sample, %	Companies in AMC, %(1)	Stakes in AMC, %(2)
Widely-held (largest stake <25%)	12	13.3	13.4	6.4
With at least one blockholder (>25%)	78	86.7	86.6	52.9
of which: majority-owned (>50%)	54	60	64	43.5
With large stakes (>25%) directly or indirectly owned by State	39	43.3	53.5	34.5
of which: with direct State stake (>25%)	13	14.4	34.1	17.4
With controlling stakes (>50%) directly or indirectly owned by State	30	33.3	50.2	33.4
of which: with direct State stake (>50%)	8	8.9	15.4	10.4
With large (>25%) private stakes	46	51.1	34.8	20.8
With private stakes >50%	24	26.7	13.8	10.1
(1) Share of combined market cap of the relevant companies in aggregate market cap of the 90 largest companies.				
(2) Share of the corresponding stakes in aggregate market cap of the 90 largest companies.				
AMC — Aggregate market cap of 90 companies included in the survey.				

Source: S&P, 2010

120. The precise size and composition of the State-owned sector in Russia is difficult to estimate. Experts suggest that the SOE sector accounts for 40-50 per cent of GDP.[27] This estimate reflects the fact that Russian SOEs tend to be larger than their private sector counterparts. They operate on a diverse range of sectors, many of which are competitive or could be if the markets were to be liberalized (Figure 1). According to public estimates,[28] while in 2004 the share of the State in the stock market accounted for 24%, it grew to reach 40% in 2007. During and after the financial crisis, it continued to grow reaching levels around 50% in 2009.

Figure 1. Participation of SOEs per sector of the Russian Economy



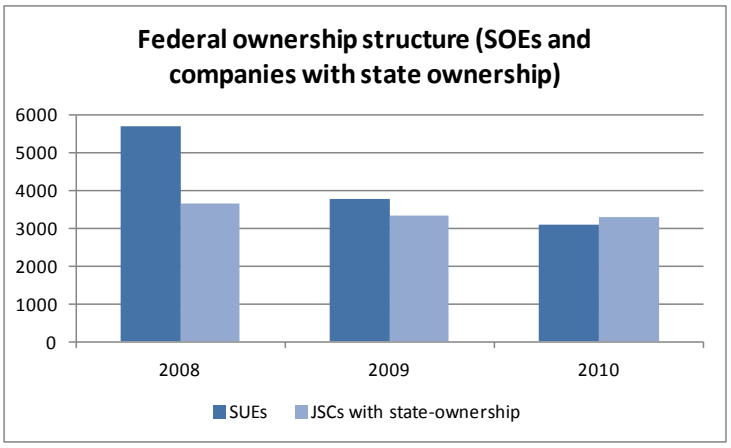
Source: MED

121. Within the Russian Federation there are three broad categories of entities that are to be included in the concept of SOE: State Unitary Enterprises[29] (hereafter "SUEs"), JSCs[30] and State Corporations[31] (hereinafter "SCs"). Within these broad categories, there is significant variation depending upon whether they are owned at the federal, regional or municipal level, and in the case of JSCs, on whether they are fully owned, majority-owned or minority owned. MED statistics for 2010 show that there were more than 18,000 enterprises with State ownership, most of them 100 per cent owned by the State at different levels. Many of these were just hospitals and schools, however.

122. Rosstat data for 2008 indicates that the Russian State was an owner of more than 9,000 SUEs at the federal level, and approximately 38,000 SUEs were held at the municipal level. The 2010 MED

figures show that at the federal level the amount was reduced to 3,113 (Figure 2). As of 2010 according to MED figures, the Russian Federation has shares in more than 3,300 JSCs and at held over 50% of the shares on more than 1,700 of those companies.

Figure 2. SOEs at Federal Level (per type and year)



Source: MED

123. The government has expressed concern about the size of the SOE sector and the need to improve its efficiency. In a speech of November 2009, then President Medvedev noted that:

> "(…) the public sector share in the economy has never gone below 40 percent, and during the crisis the State has seen its role increase, of course. This trend has been seen around the world, but from the long-term point of view there is nothing good in this. (…) I am instructing the Government to draw up resolutions for optimizing the extent and effectiveness of the State's participation in businesses' operation. This concerns the future of a number of assets that have strategic status at the moment. By 2012, we need to accomplish the relevant program and bring our State sector into line with the optimum parameters set for some foreseeable future, as nothing lasts forever."[32]

124. In June 2011 President Medvedev outlined new privatization goals for the Russian Federation in his budgetary message and also in his speech at the Saint-Petersburg International Economic Forum. Then he announced that the role of the government in management of enterprises and other assets should be decreased. Following the President's announcement, the Russian Government prepared suggestions for privatization of many large Russian SOEs up to year 2016.

125. The Federal Agency for Government Property Administration (Rosimushchestvo), established in 2004 to execute the ownership function in SOEs on behalf of the Russian State, is the State body responsible for appointing board representatives to SOEs. The Agency reports to and is overseen by the MED. For State-owned JSCs, Rosimushchestvo is in general designated as the legal owner of the shares. Also for companies included into the "special list",[33] where it votes at general meetings on issues which require instructions according to government directives, or delegates this role to individuals acting according to Rosimushchestvo's instructions. Voting of State shares for director positions takes place via directions issued after consultation with relevant central and line ministries.

126. The membership of Russian SOE boards was until recently dominated by political and administrative representatives. In 2007 S&P reported that for the thirteen largest Russian SOEs, the proportion of "external directors on the boards (though independent by formal definition only), and representatives of portfolio shareholders" was only 9%, while, for their 13 private peers, it was 25%.

The average for the 70 Russian largest public companies was 22%. As a result, control over efficiency and management was until recently regarded as weaker at SOEs, and their minority shareholders were regarded at a disadvantage (S&P, 2007). The shortcomings of these arrangements were most apparent where line ministries that had responsibility for industry regulation were represented on the board. Where the SOE had a monopoly or dominant position in an industry, the Ministry's responsibilities to regulate the industry would impact fundamentally the strategic position of the SOE.

127. In July 2008 the government announced a change of policy to improve the functioning of boards. Now, most State representatives to SOEs boards would be replaced by "professional directors", a category meant to include both independent directors and representatives of the Russian Federation who are not civil servants (the so-called "professional attorneys"). The difference between independent directors and "professional attorneys" is that the later, being the representatives of the Russian Federation, are required to vote according to instructions from the Russian State on a limited number of issues (Box 4).

Box 4. The system of instructions of professional attorneys

The issues for which instructions are issued include:

i) approval of the agenda for the shareholders' general meeting;

ii) increase of charter capital;

iii) election of executive body and termination of executive body's capacity ahead of time (both only if it is in the competence of board of directors according to the charter);

iv) recommendation to general meeting on the level of dividends;

v) approval of the major transactions;

vi) company's participation or termination of participation in other organizations (if it is not competence of executive body according to the charter), and

vii) election and re-election of the chairman of the board of directors.

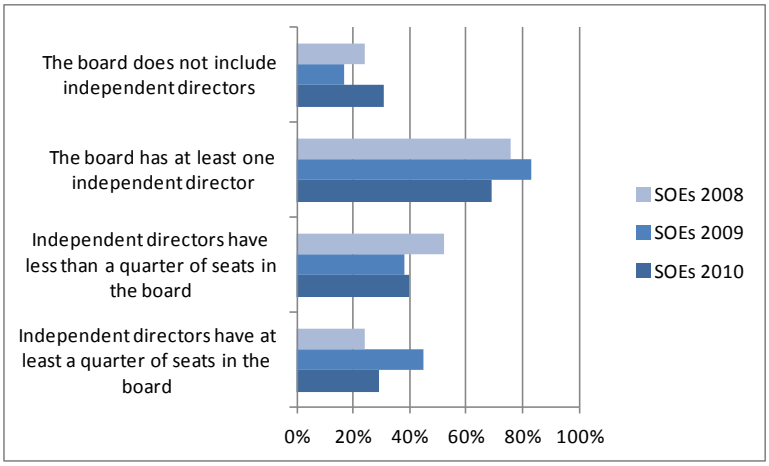
Also, instructions may be issued for issues related to fulfilling orders of the President, the Prime-Minister and First Deputy Prime-Minister of the Russian Federation.

The use of this system of instructions has been accompanied with some sort of informal indemnity agreement, whereby the directors are assured that they will not be held liable, or will be indemnify by the State, in case they follow their instructions and damages are caused to the company or other shareholders. The liability is therefore transferred to the person or authority issuing the instruction (shadow directors). A bill of law turning this informal agreement into a legal right had passed the first reading at the State Duma as of July 2012.

128. A number of new appointments to the boards of several large State-owned companies followed and a survey by the RID for 2008-2010 shows that the number of SOEs in which independent directors were nominated grew, although with a decline in 2010 (Figure 3).

129. S&P argues that some of the appointments were clear successes, such as that of Sergey Guriev to several boards including Sberbank, the appointment of Ivan Rodionov and Marlen Manasov, highly regarded finance professionals, to the board of Svyazinvest, and the appointment of Anna Belova, a respected executive and governance advocate, to the board of Sheremetyevo airport (S&P 2011). The same S&P report, however, raises doubts on the ability of the government to perform external board appointments consistently. It highlights other appointments that raised questions about the professional background of directors, and/or their ability to act independently of the government. The report offers examples such as the appointment of acting mangers of other SOEs, employees of government-funded institutions or executives of private companies that provide services to SOEs.

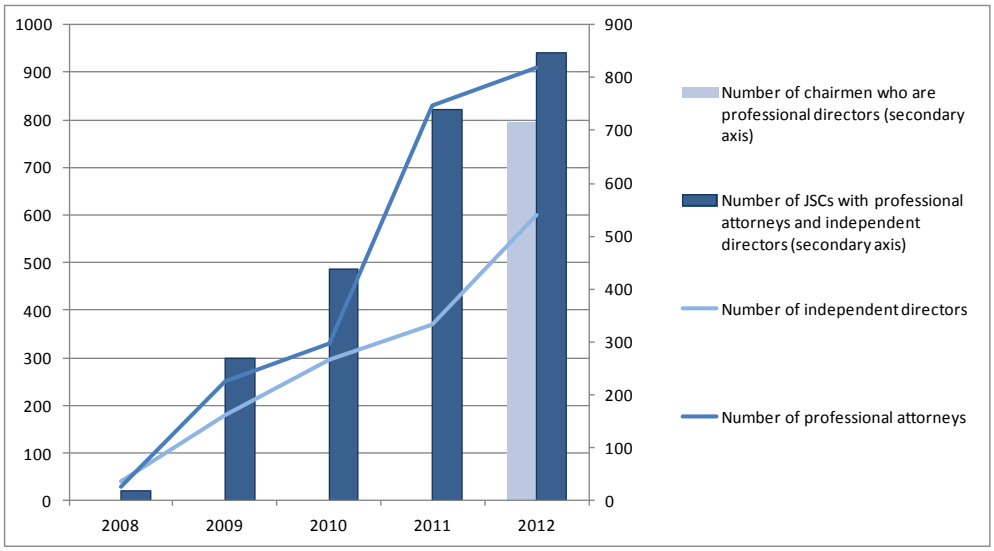
Figure 3. Independent Directors on SOEs Boards



Source: RID, *Corporate Governance Practices in Russia: 2004-2010 Comparative Study*

130. In April 2011 the President of the Russian Federation took this initiative one step further and instructed the removal of all vice-prime ministers, ministers, heads of federal agencies and members of staff of President's Administration from the boards of SOEs, as well as their replacement by professional directors. Furthermore, the President requested that civil servants no longer to act as chairmen of boards of SOEs (with the possible exceptions of defense SOEs). This Presidential decision brought Russia closer to international best practice, helped separating the State's ownership function from its market regulatory function, and should contribute to improving the autonomy of the boards and their professional competences. Figure 4 shows recent statistics from Rosimushchestvo.

Figure 4. Professional attorneys and independent directors on boards of Russian SOEs



Source: Rosimushchestvo, 2012

131. However, some doubts about the effectiveness of these arrangements for corporate governance in SOEs persist. One of the main concerns is that, in the absence of real decision-makers from the government at the board or of a real delegation of authority from government to the board, SOE boards are unlikely to be capable of taking decisions of strategic significance. This is directly related to the system of instructions (Box 4, above), pursuant to which board members that are

appointed as State representatives are required to act as instructed on a number of issues subject to board decision making. The instructions are developed by Rosimushchestvo with the line Ministries or agencies involved in the oversight of the SOE, and cover both strategic and operational matters.

132. Regardless of its exact nature or its legal obligations, directors seeking to act in the best interests of the SOE will inevitably run into conflicts with their duties to act in accordance with their instructions. The use of a system of instructions has a number of drawbacks, both in principle and practice. In a situation where Ministries are developing detailed voting instructions for board members, it is very difficult to find real exercise of independent judgment at the board. For wholly-owned SOEs and unitary enterprises, having government providing detailed instructions reduces the board to a formal role, while for partially-owned SOEs, State representatives operating under instruction effectively become advocates for government-derived policy, rather than stewards of the company, putting minority shareholders' interest in jeopardy.

133. The Russian authorities argue that the issues for which instructions are mandatory are only of a "defensive" nature, implying that they are aimed at ensuring security of State property, rather than designed to interfere with the running of the company. This is not necessarily the case with the appointment and dismissal of the CEO but, more fundamentally, the problem with this approach to exercise the State's rights is that it assumes that directors elected by the government must prefer the State's point of view over the best interest of the company or of the rest of the shareholders, and that is not in line with the Principles of the Guidelines.

134. If the State has a preference on any of the decisions subject to the board, it could inform the entire board (not only the directors it elected) about its preference, as well as of the reasons for suggesting that the board acts in one or other way. By engaging in dialog with the entire board, the State could influence its decision making in a more transparent and less disruptive way than the system of instructions. Boards around the world pay attention to their large shareholders (private or public).

135. Overall, there are many positive trends in the framework for SOE boards functioning. Given their recent nature, however, it is difficult to evaluate to what extent they are having a real impact on their governance and performance. In 2004 an observer noted that "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" (OECD, 2004, p. 15). All the steps taken in the past several years by the Russian authorities to increase the professionalism and independence of SOE boards aim to address these concerns.[34]

2.3. Independent directors

136. The Code of Corporate Governance prescribes that the board of directors should include a sufficient number of independent directors. The procedure and rules for listing securities on the Moscow Exchange set that if a company's shares are to be included in the top listing tiers (A1 and A2) then they must have at least three independent board members. In order to be eligible for lower-level quotation lists, a company must have at least one such member on its board (RID, 2011).

137. The number of independent directors is growing, both in the private and in the SOE sectors. The results of a survey conducted annually since 2003 by the RID show that the number of companies having at least one independent director has grown from 45% in 2005 to 70% in 2008 (although a drop down to 69% is observed in 2010). Boards with independent directors taking at least one quarter of seats reached 38% in 2008 from 28% in 2004, and then went down to 38% in 2010 (Table 3).

Table 3. Independent directors (full sample)

	2010	2009	2008	2007	2006	2005	2004
The board has at least one independent director, including:	69%	66%	70%	66%	55%	45%	52%
Independent directors have at least a quarter of seats in the board	31%	33%	38%	32%	23%	23%	28%
Independent directors have less than a quarter of seats in the board	38%	33%	32%	34%	32%	22%	24%
The board does not include independent directors	31%	34%	30%	34%	45%	55%	48%

Source: Российский институт директоров (РИД), 2011

138. The RID study highlights that by 2008 about one third of the surveyed companies still did not have independent directors on their boards. The share of companies without independent directors amounted to 31% in 2010. However, among listed companies this share dropped from 24% to 17% in 2009. The RID study in 2010 also stressed that the practice of having a fully independent board or a board consisting of independent and nonexecutive directors is not developed.

139. According to the recent survey by PwC and the IDA (PwC, 2012 b), a majority of the top 50 Russian public companies define a minimum number or percentage of independent directors on their boards (with two of them requiring that to be half or more of the board), and this is reflected in the presence of one to nine independent directors in those boards (from 9% to 86% of the total). The average is to find 4 independents in a 10-person board, but the survey warns that "one can hardly assert whether these independent directors are truly independent" (PwC, 2012 b, p. 10), as the independence criteria that companies apply differ significantly from one to another. This highlights an important issue with the definition of independence, as there are several competing criteria in the legislation and regulation (Box 5).

140. The lack of clarity about what constitutes an independent director has brought confusion to the market, and experts have created new categories to informally classify some independent directors as professional directors, outside directors or minority representatives. Some of the examples where the lack of clarity are more evident can be found where holding company representatives are sometimes regarded as independent, as well as employees of institutional investors' or investment banks' managers.

141. The same could be said for some public employees that appear as independent of the State when acting in the board of an SOE. Another issue is the criterion that allows a person representing the interests of individuals or organizations that are bound by a contract with a SOE to be considered as independent directors in that SOE, if the total amount of transactions between the parties during the year is less than 10% of the book value of the assets of the SOE. Given the enormous book value of the assets of some of the Russian SOEs, the current rules allow independent directors represent counterparties with huge contracts and equally big potential conflicts of interest.

142. The PwC and IDA survey notes that "when determining whether or not a director is independent almost half of the companies apply only the minimum independence criteria set out in the Law on JSC" (PwC, 2012 b, p. 12). The Corporate Governance Code is also used by 42% of the surveyed companies and a further 15% uses the UK Code, mostly as a result of cross-listing. When asked to describe what backgrounds they look for in a candidate for an independent director position, respondent of the survey list "retired top executives" (62%); "active top executives" (52%); "professionals" (46%); and "retired regulatory/government representatives" (29%).

143. As mentioned in the previous sections, according to the OECD Guidelines some of the key elements of a robust board nomination policy framework for SOEs are to specify the person or body responsible for nominating the board member and being transparent about the procedure and the qualifications that may be required. In Russia, the procedures for selecting independent directors to the

boards of SOEs are not defined in the legislation or regulation, but there are internal guidelines adopted by Rosimushchestvo.[35]

Box 5. The Definitions of Independence

The JSC Law (article 83) stipulates the requirements for independent directors solely as an issue for approval of related-party transactions. It says that a board member shall be deemed to be independent if he/she is not and during twelve months immediately preceding the approval of transaction was not: "(i) a person exercising the functions of a one-man executive body of the company, its manager, a member of its collegiate executive body or a person holding positions on the governing bodies of the managing organization; (ii) a person whose spouse, parents, children, full- or half-blood siblings, adoptive parents or adoptees hold positions in the aforementioned governing bodies of the company or of the managing company, or the position of the company's manager; or (iii) an affiliated person of the company except for members of the board of directors/supervisory board of the company."

The Corporate Governance Code stipulates that directors shall be deemed independent if they are not: "(i) and have not been for the last three years company officers/managers or employees, or officers or employees of the managing organization of the company; (ii) officers of another company where any of the company officers are members of the Personnel and Remuneration Committee of the board of directors; (iii) affiliated persons of an officer/manager of the company (officer of the managing organization); (iv) affiliated persons of the company or affiliated persons of such affiliated persons; (v) parties to any obligations with the company whereby they may acquire property (receive money) valued at ten or more per cent of the total annual income of said persons in addition to their remuneration for membership on the board of directors; (vi) major counterparties of the company (i.e. are not counterparties whose aggregate transactions with the company account for ten or more per cent of the book value of the company assets); and (vii) government representatives."

The FFMS Regulations issued in 2007 stipulate that for listing shares in the A tier of the stock market, no fewer than three members of the board of directors of the issuer must not be: "(i) officers or employees of the issuer (manager) at the time of, and during 12 months prior to, their election; (ii) officers of another business entity, where any officer of this entity is a member of the board of directors Personnel and Remuneration Committee; (iii) a spouse, parent, child or sibling of officers/managers of the issuer (officer of the managing company of the issuer); (iv) an affiliated person of the issuer except for a member of the board of directors of the issuer; (v) parties to any obligations with the issuer under which they may acquire property (receive money) whose value is 10 and more per cent of the aggregate annual income of the said parties in addition to their remuneration for servicing on the board of directors of the company; and (vi) government representatives, i.e. persons representing the Russian Federation, its constituent entities or municipalities, on the board of directors of JSCs, in respect of whom it was decided to exercise the special right ("golden share"), or persons elected to the board of directors from among the nominees of the Russian Federation, its constituent entities or municipalities, if such members of the board of directors must vote in compliance with written directives from the constituent entity of the Russian Federation or the municipal entity respectively."

Government Resolution No. 738 of 2010 introduced specific independence criteria for government nominations to the boards of SOEs. These are based on the Code but also develop specific requirements for a director not to be related to the State. The Resolution prescribes that the persons nominated by the government must not: (a) hold positions in the State civil service of the Russian Federation or be an employee of the Central Bank of the Russian Federation; (b) be board members in the company to which they are nominated for the past five consecutive years; (c) be officers or employees of another joint-stock company in which any of the officers of the company to which the person is nominated is a member of the board's nomination and remuneration committee; and (d) be independent directors in more than three joint-stock companies at a time.

A draft update of the Code developed by the IDA and the RID suggests that a member of the board of directors shall be deemed independent if he/she: "(i) is not and has not been for the last three years an officer/manager or employee of the company or an officer or employee of the managing organization of the company; (ii) is not an officer of another company where any of the company officers is a member of the board of directors Personnel and Remuneration Committee; (iii) is not an affiliated person of the company or an affiliated person of such affiliated persons; (iv) is not an affiliated person of an officer/manager of the company (officer of the managing organization); (v) is not a government representative; (vi) does not own directly or through affiliated persons equity stakes in the company, sufficient for self-nomination to its board of directors; (vii) does not receive remuneration for consulting and other services provided to the company other than the remuneration for board membership; (viii) does not represent consultants or counterparties working with the company; (ix) has a good business standing, abides by high moral standards and possesses necessary leadership qualities and entrepreneurial experience; and (x) has publicly declared his/her independent director status prior to election to

the board of directors."

The IFC Working Group has also proposed a number of criteria for independency. It states that an independent director cannot be the person who, or whose spouse, parents, children, full and half brothers and sisters, adoptive parents and adopted children, or other affiliated persons are or were in the past three years directly or indirectly determined (or controlled) by the company, or by its affiliate, or by a shareholder of the company holding a number of voting shares of a company allowing him/her to select at least one member of the board of directors, or an affiliate of such shareholder in their decisions making, including (i) employees or persons holding positions in the management bodies of the Company or its affiliate, or a shareholder of the company holding such number of voting shares of a company that allows you to select at least one member of the board of directors, or an affiliate of such shareholder or the management entity to which the powers of the sole executive body of the subsidiary or affiliated companies society were given; (ii) affiliates of the company or of its subsidiaries or affiliates, or of a shareholder of the company holding a number of voting shares of a company allowing him/her to select at least one member of the board of directors, except when the only ground of affiliation was that the person to be elected as an independent director hold for nor more than 7 years the position of as a member of the board of directors; (iii) persons entitled to, directly or indirectly dispose not less than 2 percent of the total votes attached to the voting shares in the company; (iv) persons with other links with any person if these links allow the company, its affiliates, shareholders of the company holding a number of voting shares of a company allowing him/her to select at least one member of the board of directors, or affiliates of such shareholder, determine the decisions of such persons directly or indirectly. The IFC Working Group also proposed to adopt the criterion that civil servants, municipal officials, and staff of the Bank of Russia cannot hold position of an independent director; that the same person cannot be an independent director at the same time in two affiliated companies, and some other criteria.

144. A special Commission for selecting independent directors was established at Rosimushchestvo in 2009 to play the role of a centralized unique body responsible for nominating board members. The Commission is a permanent body comprising representatives of Rosimushchestvo, of the federal authorities responsible for the relevant areas of industry or business, and representatives of professional organizations (the RID, the IDA, the OKDM and the OPIAK, among others). These organizations are potential suppliers of independent directors and professional attorneys, who they select from their own membership, indirectly influencing the screening process with the criteria and standards that each of them apply to admit their members. Rosimushchestvo is said to be working with some of these organizations to increase the preparation of these candidates.

145. In a survey conducted by KPMG, Anna Belova reported positive changes on corporate governance practices of SOEs, highlighting the importance of independent directors and professional attorneys on their boards (KPMG, 2011). Belova recounts significant progress in the last 5 to 7 years, recounting that at the beginning g of the period most boards had no committees, there were no agendas for meetings, and voting by board members was rather a formality than exercise of substantive corporate management, with the vast majority of government officials not devoting much time or efforts into their work on boards. For this reason, she emphasizes the role of independent directors and argues that their success will depend on the attitude they take towards their duties. She stresses the importance of independent directors realizing their responsibility over corporate governance and their accountability for it.[36]

146. The debate regarding the definition of independent directors (for all types of companies) is ongoing. One of the several pending initiatives aimed at improving board practices, not yet submitted to the State Duma, proposes to introduce various changes to the JSC Law. This draft bill available on the web-site of the FFMS[37] is aimed at requiring listed companies trading on domestic stock exchanges, to elect a minimum number of independent directors. It proposes that the exact number should be defined in the company's charter. It also proposes that the charter should set standard criteria to classify a board member as independent. Such criteria should be uniform, non-discriminative, unbiased, address professional background and competence of a candidate, and contain no personal references on individual basis. This draft bill would not change the existing statutory definition of "independent director", but it would rule out decisions of a board, other than preparing

and convening general shareholder meeting called to re-elect the board of directors, where the required quota of independent directors is not met.

147. There is also a FFMS proposal to update the definition in the Code of Corporate Conduct and to set more rigorous requirements, as well as pressure from some professional associations to raise the status of the definition by incorporating it to the JSC Law, not only for related party transaction issues. In particular, it has been proposed to abandon the use of the term "independent director" in relation to the approval of transactions with related parties, while maintaining the overall approach in which joint stock companies are to disclose information in accordance with the securities market legislation if required by its charter. The decision to approve the deals with related parties should be made by members of the board of directors who are not interested in the transaction and meet more stringent requirements (criteria) aiming to exclude potential conflicts of interest.

148. Experts involved in formulating requirements to independent directors in Russia acknowledge that independent status in itself is not enough to have a positive impact on the company's performance. They also point out to the fairness of the nomination procedure and to competence requirements (Gutnikova 2012). The procedure plays an important role in ensuring that the board will have members able to exercise independent judgment and affect the credibility of the overall corporate governance framework. Directors should not only be independent, but competent, they must have appropriate reputation and sufficient amount of time to devote to the company. In her study on independent directors, Gutnikova suggests to complete the existing legislation with competence and reputational requirements (Gutnikova, 2012).

149. A KPMG survey also concludes that the criterion of independence by itself is not a guarantee of high board member's performance and argues that professional competence and experience in the areas relevant to the company should go along with the independence (KPMG, 2011).

2.4. Board committees

150. The Russian Code of Corporate Conduct recommends that companies should determine the number of committees they create "so as to enable the committee to review matters under consideration in the most comprehensive fashion and taking into account the opinions of all members", that "participation of members of the board of directors in multiple committees should be restricted" as well as that committees should be "headed by members of the board of directors who do not hold official positions with the company." [38]

151. The PwC and IDA survey of board members shows that two out of three companies in the sample have a nomination committee or equivalent body (often integrated with the functions of remunerations committee), with 4 members of average and two of them being independent directors (and between two and three on average among listed companies). Additionally, in 70% of the top 50 Russian public companies the chairman of the nomination committee is an independent director (PwC, 2012 b). However, the survey also argues that in practice these committees:

> "normally do little about non-executive directors' search and selection. Indeed, their function related to nomination is often limited to suggesting candidates to top-executive positions. Though, some of our interviewees believe the role of the nomination committee tends to evolve rapidly, and even today one can see some good examples of committees leading the process for board appointments" (PwC, 2012 b, p 26).

152. Appointment of potentially good directors is only part of the equation. Once on the board, they need to be able to exercise their judgment in a meaningful and constructive way. However, as described by one well reputed independent director, one of the many definitions for independent director is that of a director "upon whom nothing really depends." This is said with humor as to reflect

the fact that the committees and other instances where these directors could be most useful are, in practice, often irrelevant for companies. In some cases, the audit committee is not even made up from board members.[39]

153. In Russia, the FFMS' regulations and exchange listing requirements prescribe that A1-level listed companies should have an audit committee as well as a nomination and remuneration committees. For the A2 level, companies only need to have an audit committee.

154. The 2011 RID survey has noticed that audit, nominations and remuneration committees have become more common and some positive trends (Tables 4 and 5) in the creation of board committees can be perceived: i) the share of companies with an audit committee increased to 77% by 2009, and in 2010 reached 80%; ii) companies subordinating their internal audit bodies to the board of directors has increased to 70% in 2010; and iii) the practice of introducing the mechanisms to handle conflicts of interest among board members has become more common, with the share of companies that have created such mechanisms increasing to 85% by 2010.

Table 4. Board-level committees (full sample)

	2010	2009	2008	2007	2006	2005	2004
The board has an audit committee	80%	77%	69%	51%	41%	32%	23%
A board has a personal and remuneration committee	73%	65%	55%	33%	27%	23%	19%

Source: The 2011 RID survey

Table 5. Board-level committees (per type of company)

	Listed companies							SOEs		
	2010	2009	2008	2007	2006	2005	2004	2010	2009	2008
The board has an audit committee	99%	99%	95%	95%	83%	67%	56%	63%	72%	57%
A board has a personal and remuneration committee	94%	85%	75%	66%	56%	49%	48%	71%	69%	48%

Source: The 2011 RID survey

155. With regard to the SOE sector, the OECD Guidelines also suggest that SOEs' boards should set up specialized committees to support the board in performing its functions, particularly with respect to audit, risk management and remuneration policies. In Russia the use of specialized board committees in SOEs has increased, in line with practices in the private sector, and many Russian SOEs have implemented board committees. Rosimushchestvo recommends all SOEs to set up three specialized committees: (i) a strategic planning committee; (ii) an audit committee and (iii) a personnel and remuneration committee. It has also been proposed that chairpersons of these committees are elected from members of boards of directors who are not civil servants.

156. However, a study conducted by S&P indicates that independent audit committees may not be widespread, and that some SOEs are particularly reluctant to yield control over the audit process to independent board members. This weakens auditor selection and supervision procedures and does not allow the internal audit to be independent from management and significant shareholders. Due to an explosion in demand for audit specialists, competent internal audit staff is said to be in short supply in Russia. As a result, it is reported that even the large public companies typically have only a small internal audit department reporting to the audit committee, and a much larger "controls" or "revisions" outfit reporting to management and performing extensive fieldwork that is not based on risk analysis and not coordinated with internal auditors' work (S&P 2011).

157. Pursuant to a legacy issue from Soviet law, together with the audit committee of the board there is a similar "revision commission" that creates competence issues with the audit committee. This commission is elected by shareholders at the AGM by simple majority, and for that reason is often picked by the controlling shareholder (AEB, 2010, p. 176). Moreover, it does not report to the board

and has some superimposing duties with the audit committee, since its main responsibility is to approve the financial statements under RAS before the annual shareholders meeting.[40] According to the RID survey, as of 2010 more than half of the companies in its sample include the members of management and employees into their revision commission (RID 2011). Reports mention that is has been proposed to introduce a legal reform to address these issues, with the possibility of allowing JSCs to elect to choose to have either a revision commission or a board audit committee (with the chance to voluntarily have both).

2.5. Responsibility and fiduciary duties of board members

158. Fiduciary duties are an important factor in the framework for a well performing board of directors. The fact that shareholders can hold boards accountable for poor performance or negligence, and that the board members risk bearing financial losses or even criminal sanctions, has consequences on their behavior. This deterrent effect is important for the efficiency of the board.

159. Guriev says that fiduciary duties are one of the key incentives for an ideal model of boards, together with electoral and career and reputation-related incentives (Guriev 2012). However, the fiduciary duties of a Russian board member are not well defined in the legislation, as the duties of loyalty and care are not well developed. Pursuant to Russian law, only a broad statement is given in the sense that the board is liable to shareholders: "a director is to exercise his discretion and expertise in acting in the utmost faith and best interests of all shareholders." The main drawback is that the current definition it is very general, not clear on what kind of behavior shall be deemed unfair or unreasonable, and what should be the grounds for triggering liability. This is said to nullify the potential deterrent effect and possible liability hardly plays a decisive role in motivating board members for better performance.

160. The Code of Corporate Conduct also contains more developed recommendations to this effect, but the courts do not recognize Code's recommendations as binding and do not take them into account when ruling on directors' liability. Analysis of court practice shows that claims against board members for losses caused to the company are rarely submitted. And decisions by the courts to recover the losses are infrequent, primarily due to the fact that the entire burden of proof is on the claimant, and the courts have difficulties to use the category of good faith and reasonableness.[41]

161. Concerned with this situation the Russian authorities submitted a bill of law to the State Duma with a better definition of the liability of the board, including shadow directors (Box 6). The law would introduce the concepts of "duty of care" and a "duty of loyalty" and offer a set of the criteria of imprudent and unfair behavior. The bill aims to establish a framework by which to decide whether and to what extent the company directors properly discharge their duties to the company and its shareholders. This would improve the current situation where, in practice, board members are said to be free of liability on corporate issues, although they may have liability in case of fraudulent or negligent bankruptcy.

162. Although the legal framework permits directors' liability insurance, and companies can make use of it, the practice is not widespread. Some argue that because of this, shareholders have no incentives to sue board members, as it is highly unlikely that average board members' personal property would be sufficient for compensating shareholders losses, or even court expenses. Guriev suggests that board members are furthermore not afraid of shareholder's lawsuits because they do not consider the Russian judicial system as a credible threat. He points to lack of competence and scope for corruption and argues that an honest and competent judiciary is one of the major challenges in Russia (Guriev, 2012).

163. Key reforms in the pipeline for the Civil Code may also have a strong influence on boards functioning and responsibility. These relate to new regulation being proposed to better define when

parties are to be regarded as affiliated and to define who is "controller" of a legal entity. All these issues are linked to key recommendations of the Principles dealing with the equitable treatment of shareholders and address prominent loopholes in current Russian law. For example, current affiliation rules permit that an individual not officially registered with the tax authorities as an "entrepreneur" –a voluntary registration– are regarded as not having affiliation. These rules also have a closed (and quite short) list of grounds under which affiliation can be determined. Likewise, according to the current rules, in Russia only a corporation can be recognised as controlling another legal entity. Individuals or other type of legal entities are always excluded from the definition and can escape being subject to these rules. Furthermore, current rules allow actual control to be hidden via holding companies and go unregulated and unburdened by minority shareholders protection rules.

Box 6. Amendments to the Law on fiduciary duties and liability of corporate directors

The bill of law amending the JSC Law and the Securities Market Law, Bill N° 394587-5, was proposed by the government in June 2010 and is now under the second reading.

The bill further elaborates and defines the rules in the SM Law this norm to reconcile with the existing norm in the JSC Law, regarding breach of duty and procedures for filing lawsuits by dissenting shareholders. It introduces the liability of executive directors (including current and former management and acting CEOs), who sign the company's share prospectus, quarterly reports and for non-executive directors who approve these documents. For this purpose, it is proposed to introduce a practice whereby the board member voting ballots (or written agreements) should be included in the minutes of the meeting (the board meeting protocol).

In the case of the JSC Law, the bill proposes to elaborate and streamline the existing rules of article 71 (revised in 2006). Currently law is applicable to both private companies and SOEs, but the new law relieves government officers from legal liability when acting under the system of instructions, case where liability is assigned to the government. The bill also introduces and defines the liability of the CEO and members of executive board for delinquent share dividend or bond interest payments, violation of statutory buyout rules and share pricing policy.

Under these rules, shareholders owning 1% or more of the ordinary outstanding shares of the company may sue directors in court for the losses caused by not performing the responsibilities in the best interest of the company. The bill also authorizes the company to insure the wrongdoing risks on behalf of executive and non-executive directors, current as well as former and future, subject to approval by its shareholders.

Source: Duma's website, legislation database; OECD

164. The new definitions proposed for the Civil Code will solve these problems and will further allow a court, as in most OECD countries, to be able to determine affiliation or control on a case by case basis, depending on the circumstances as in the "acting in concert" provisions of many developed jurisdictions. Addressing these loopholes will increase shareholder protection in Russia and facilitate implementation and enforcement of Russian corporate law on several other related areas, including those dealing with board independence requirements, voting on elections, dealing with conflicts of interest and disclosure of beneficial ownership.

III. CONCLUSIONS

165. The framework for nomination and election of board members in Russia has been developed in a short period of time and while the ownership structure of the equities market was still in flux. As a result, current rules and practices are a mixture of strong and weak points, with an overall adequate level but prominent loopholes that undermine its functioning at crucial crossroads. Indeed, most of the laws and regulations are consistent with the Principles and Guidelines, but there are still areas where further progress is needed and where practices still fall behind. Considering the short timeframe, however, progress is evident and deserves more credit that it normally receives, mainly due to the extensive coverage of corporate scandals and disputes of recent years.

166. A decade ago the OECD Russian Corporate Governance Roundtable reviewed the corporate governance practices in Russia and offered a number of recommendations, including in the area of board formation (Box 7). Some of these recommendations have already been addressed or are being implemented. That is the case of electing more independent directors on boards, introducing professional directors for SOE boards, respecting procedures of cumulative voting for electing board members, strengthening the role of the nomination committee. Others need further efforts from both the State and the private sector to comply with best practices, such as ensuring a transparent nomination process and providing shareholders with timely and complete information on candidates, further developing the definition and criteria for an independent director, as well as further promoting director's skills and experiences through training.

167. Shareholders in Russia have the right to elect and remove members of the board, have the opportunity to participate and vote in AGMs. Their effective participation in the nomination and election of board members is facilitated at a reasonable level, although disclosure seems not to be enough. The Principles also call for transparency of the process and for disclosure of information about key aspects of the board formation process. Best practice among OECD countries shows that better informed shareholders choose more effective boards. It is suggested that in Russia some of these functions are being performed by proxy advisors, but shareholders should benefit from direct access to this information. Particularly, they should receive information about the experience and background of candidates to the board, as well as about other nominations they have accepted.

168. The Principles state that the board has an essential role to play in the nomination process. There is an ongoing reform in Russia aiming to improve the power of the board to nominate candidates, particularly independent directors, even when shareholders have proposed their own preferences for the board. The implementation of this reform would make practices in Russia more consistent with best practices and the role of board nomination committees in developed markets.

169. In terms of the functioning of the boards, many experts point to significant improvements in the last decade. More professionalism, further board committees and higher performance are often mentioned. However, in practice, the role of some boards is often diminished by strong influence from controlling shareholders (private or public) or from their representatives in the management board, which is typical of highly concentrated ownership markets. These boards do not play a critical part in steering the company's business as the majority shareholders' control remains the key corporate governance factor.

Box 7. White paper from the 2002 OECD Russian Roundtable

In 2002 the OECD Russian Corporate Governance Roundtable, which met regularly between 2002 and 2008, and has been re- launched in 2011, has adopted a White Paper with specific recommendations for Russia taking the OECD Principles as a point of reference. The White Paper has established a direct link between the Russian corporate governance practices at the time and internationally recognized standards and made a contribution to the shaping of the reform agenda in the area of corporate governance in Russia.

The White paper has a separate chapter devoted to the responsibilities of the board of directors. It shortly describes the legal framework at the time and develops a number of specific recommendations, including those which are applicable to the nomination and election of board members.

It highlights that directors appointed by controlling shareholders have a duty to represent the shareholders collectively and not just in the interests of the group that nominated them or otherwise influenced their election. This attitude allows them to act in the interests of the company and treat shareholders in a fair and equitable manner. A particular concern was raised with regard to the SOEs where the nomination of officials as board members leads to the conflict of interest (regulation or oversight of the company). The Paper recommends not nominating such officials as board members.

The White Paper also recommends developing practical guidance for the board members' legal duty to act reasonably and in good faith. For this purpose producing a guide (probably in cooperation with the RID) including examples of proper conduct and references to authentic cases would be very supportive. Provide training and orientation on the basis of such a guide is also promoted.

The Paper highlights the existing issues with the definition of an independent board member and stressed the importance of respecting the procedures of cumulative voting because it allows minority shareholders to support genuinely independent candidates for board membership.

The White Paper also stresses the importance of promoting director's skills and experiences through training and board performance evaluation and the real situation at the time with a relative shortage of people with suitable business experience. An important consequence of improving competences is more professional and informed decision making and better performance of key tasks by board members which include not only procedural tasks, but also monitoring and evaluating senior management, providing strategic guidance, management of conflicting interests. The White Paper promotes dedicating sufficient resources by a company for the training of board members including induction training for new non-executive board members. Professional associations of board members in Russia have a role to play in this process, namely to train a core group of qualified professionals and to create a database of suitable domestic and foreign candidates to board of directors.

The role of a nomination committee to assist boards in identifying candidates and ensuring a transparent nomination is also addressed in the Paper. It promotes creating such committee and putting independent directors in them. When addressing the nomination process the White Paper also recommends ensuring that shareholders are provided with maximum information on all candidates sufficiently in advance of the general meeting.

When providing recommendations with regard to disclosure practices, the White Paper suggests expanding disclosure of non-financial information and materials for investment and voting decisions in addition to the basic financial information, including the information on board members.

Source: OECD 2002

170. The absence of well defined concepts of controlling persons and affiliates, two prominent loopholes in Russian law, often allow these insiders to act without liability for potential abuses of power. A proposed reform of the Civil Code may solve these issues. If complemented with a strong and competent judicial review of corporate governance issues, could significantly improve the Russian corporate governance framework.

171. In the SOE sector, Rosimushchestvo's work has modernized the process and improved the results of board formation. The Presidential decision to remove high level politicians has also better

aligned Russia with international best practice. The OECD Guidelines recommend that the State let SOE boards exercise their responsibilities and respect their independence. Progress has been observed in Russia, especially with the introduction of professional attorneys and independent directors on boards. The system of instructions is still a setback, and the Russians State could benefit from reconsidering the use of alternative methods to communicate with boards of SOEs.

172. Overall, progress is evident and widely acknowledged. Areas for additional efforts include high profile issues, like the definition of independence, more transparency of the board formation process, stronger fiduciary duties, and further improvements in the compliance and enforcement of the framework. The legal rules are essential, but not solve the problems if practices are not aligned with them.

173. The actions of shareholders, managers, boards of directors and regulators are essential to determining the corporate governance culture of a country. Boards play a key role in setting the tone at the top of companies and through their behavior to the rest of the market. A sound set of rules and practices for board formation in Russia is developing and should be further encouraged.

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NOTES

[1] The Principles are recognized worldwide as an international benchmark for sound corporate governance and have been adopted as one of the Twelve Key Standards for Sound Financial Systems by the Financial Stability Board. Agreed by OECD governments in 1999 and revised in 2004, the Principles provide specific guidance for policymakers, regulators and market participants in both OECD and non-OECD countries in improving their legal, institutional and regulatory frameworks.

[2] Delaware is the most influential State on corporate law since the majority of U.S. listed companies have elected to incorporate there, as well as because Delaware's well-developed corporate law statutes and jurisprudence are followed closely by other states.

[3] In the US, shareholders have different options to influence the nomination and election process for the board, some within and some outside of the proxy process. Shareholders may submit nominations for director to a company for consideration by the nominating committee or board. If the company declines to include the nomination in the company's slate of candidates for directors, shareholders may attend the shareholder meeting and present a candidate, subject to the company's advance notice bylaw. However, without having a candidate listed in the proxy statement and proxy card, success would be difficult. Within the proxy process, shareholders have the right to vote for the candidates included in the proxy statement, which will normally include only those candidates nominated by the nominations committee or by the board, where there is no nominations committee. If shareholders are not satisfied with such candidates, they may vote against the company's nominees in full or part. They may also, at their own expense, opt to challenge the company's nominations and start a proxy contest to obtain votes in favor of different candidates. This is not done frequently because without access to the company proxy documents, any nomination taken to a vote by the AGM is costly.

[4] Sir Adrian Cadbury, Former Chairman of Cadbury Schweppes, United Kingdom

[5] Mr. Jack Krol, Lead Director at Tyco International, USA

[6] Mr. Jesus Estanislao, Chairman/CEO of the Institute of Corporate Directors, Philippines

[7] Ms. Michele Hooper, Managing Partner at the Directors' Council, USA

[8] Dr. N. Balasubramanian, Professor and Chairman of the IIMB Centre for Corporate Governance and Citizenship, India

[9] See for more information http://www.ft.com/intl/cms/s/0/35de130a-0095-11e2-8197-00144feabdc0.html#axzz27NbboPbF, http://www.ft.com/intl/cms/s/0/1723c18e-01cc-11e2-8aaa-00144feabdc0.html#axzz27NbboPbF

[10] The approval of a major transaction of 25 to 50 percent of the book value of the company's assets is done by the Board of Directors (Supervisory Board) unanimously, the votes of retired members of the Board of Directors (Supervisory Board); a major transaction involving more than 50 percent of the book value of the Company, is approved by three-quarters of votes of shareholders - owners of voting shares participating in the GMS (art. 78 of the JSC Law).

[11] Related party transactions of less than 2% percent of ordinary shares or 2% percent of the book value of the company according to its financial statements as of the last reporting date, are to be approved by the board of directors. Above those amounts need to be approved by the AGM or EGM (art.83 of the JSC Law).

[12] There are weaker requirements for companies listed on lower tiers and for issuers of debt instruments.

[13] Only banking institutions are required by law to have dual-tier boards.

[14] See http://www.forbes.ru/news/123780-minfin-sozdast-finansovyi-megaregulyator-na-baze-fsfr-i-tsb-k-kontsu-2013-goda and http://www.vedomosti.ru/finance/news/3862771/minfin_finansovyj_megaregulyator_na_baze_fsfr_i_cb_nuzhno,

[15] In practice, however, this term can last more than one year: AGM takes place in February – June and if there is no board re-election in EGM, a board member elected in February can serve to the following AGM, which can be called for in June of the following year.

[16] By March 2010, the total amount raised by Russian companies via 79 IPOs and SPOs was $62.7bn. That does not include private placements or equity injected by the State into SOEs. The busiest year was 2007, when a total of $32.9bn was raised via 29 issues. Business New Europe, *Almost $10bn of Russian IPOs ready to go*, March 19 2010.

[17] It is also worth mentioning that there are several Russian companies that have opted to list only abroad, even though their operations are fully Russian. A few examples of large, de-facto Russian, companies incorporated abroad are CTC-Media (media industry, incorporated in Delaware), X5 Retail Group (in the retail business and incorporated in the Netherlands), Evraz Group (metallurgy, incorporated in Luxembourg), Sibir Energy (oil & gas, incorporated in the U.K.), and UC Rusal (metallurgy, incorporated in Jersey, U.K.) (Enikolopov and Stepanov 2012).

[18] See the official web-site at http://www.rusal.ru/en/about/facts.aspx

[19] The survey was conducted in July 2012 and covers 83 professionals from a range of large and small, public (39) and closely held (44) companies of many different industries.

[20] The decision must be made 30 days after the end of the financial year, or 30 days before the date of the EGM unless the company's charter sets it later (i.e. 35 days before the nomination period)

[21] For the general shareholders' meeting conducted in absentia and for the general meeting of shareholders in the companies with 1000 or more shareholders, as well as for the companies whose charter provides for it, delivery of ballots before the shareholders general meeting ifs mandatory and the ballot should be sent or delivered against signature to each not later than 20 days prior to the meeting.

[22] Investor Protection Association website, http://www.corp-gov.ru/projects/itogi_2011.php3

[23] The results of AGMs of Russian companies 2012, Investor Protection Association, http://www.corp-gov.ru

[24] Code of Corporate Conduct, Chapter III, Par. 2.3.1

[25] Code of Corporate Conduct, Chapter III, Par. 2.3.

[26] It should be stressed however, that the position of the board secretary when properly designed and free of any political influence helps effective functioning of the board of directors and thus constitutes one of the elements of a robust corporate governance framework.

[27] The exact number is difficult to determine as GDP reporting breakdown is done by industry, regardless of ownership. Assumptions are often made by using the ownership structures in each industry and

multiplying to the respective weight in the GDP. Out of 90 largest public companies included in S&P´s 2009 Annual Transparency Survey, capitalization-weighted share of the SOE sector was about 55%.

[28] See Vedomosti No. 169 from 7/09/2012, http://www.vedomosti.ru/politics/news/3683391/zarabotat_40_mlrd

[29] SUEs are a unique creation of the Civil Code of the Russian Federation. They can only be established by the State (either at the federal, regional or municipal level). They are distinguished by the fact that they do not own the underlying immovable property which forms the basis of their commercial operations. Instead, that property is, and must remain, under the ownership of the State body that established the entity. SUEs do not have ownership shares; instead they are fully controlled by the Russian government at the corresponding level. SUEs are generally commercially focused organizations that have a separate legal form and are organized to operate as businesses. SUEs are further classified according to whether they hold their assets in 'right of economic management' or in 'right of operative management'. Where the assets are held under the 'right of economic management', an SUE has many rights similar to ownership rights, in that it can use and dispose of its movable property (including proceeds and revenues). However, an SUE cannot sell, rent or mortgage any immovable property, contribute it as an investment into joint ventures or partnerships, or to dispose of it in any other way without the consent of the owner. Where the assets are held under the 'right of operative management,' SUEs' rights to dispose of the assets are even more proscribed. For these SUEs, their liabilities are guaranteed by the asset owner, whereas for the first type that is generally not the case.

[30] SOEs incorporated as JSCs can be either open or closed. Open JSCs may not impose limits on the number of shareholders and shareholders may transfer their shareholdings without the permission of other shareholders. Hence, this is the ownership form adopted for listed SOEs. Furthermore, since 1996 JSCs which are created and which have government shareholding –including regional and municipal governments– must be incorporated as open JSCs whether they are listed or not. The only closed JSCs that have government shareholding are those that were created prior to 1996.

[31] State Corporations are entities established under their own legislation and for which governance arrangements are embedded in the individual statutory laws. They respond to the desire of the government to achieve certain strategic goals in the respective area where the corporations operate, acting as part of the public sector but with the management function acting according to the rules of the private sector. Increased use of this structure was seen in 2007-2008, whereas the legal basis for establishing SCs was established already in 1999 with the amendment to the Law on Non-commercial Entities. This law specifies that the establishment of SCs can be done for carrying out social, managerial or other socially useful functions, which is a wide mandate. Until recently, eight State corporations operated in Russia, each of which was created to advance specific priority national projects. While they are relatively few compared to the number of JSCs and SUEs, the scope of activities and size of SCs is very significant. In 2008, in addition to receiving assets originally belonging to the government, 920 billion RUB ($32 billion USD) were allocated for financing their SCs' activities (6 per cent of the central government's consolidated annual budget) (NCCG, 2009).

[32] Presidential Address to the Federal Assembly of the Russian Federation on 12 November 12 2009, available at http://www.kremlin.ru

[33] The "special list" is an internal classification at the Russian government, defined by Government Decision # 91-p, listing companies that are partly or totally removed from the control of Rosimushchestvo and handled directly from government, where the Prime Minister or Deputy Prime Ministers act as the final decision-making bodies. At present the special list includes 66 JSCs: 36 in Annex 1 and 30 in Annex 2.

[34] The 2009 RID survey concludes that positive changes in the corporate governance practices of State-owned and other companies are not yet comprehensive. The government's efforts to hire independent directors to companies could be viewed as the first steps toward changing the model of management which the State uses. The transition from "manual steering" via government officials to the model of truly strategic management and control would be a very timely step. If the appointment of independent

directors is viewed as a self-sufficient action per se and will not be supported by the cover-all enhancement of the governance practices, there is a high likelihood that the targeted improvement of effectiveness will not be achieved (RID, 2009).

[35] The Commission decides on the needs to attract professional directors to the management and control of SOEs and selects candidates for election to the board of directors and to the audit unit. Information about the Commission and about the SOEs to whose boards the election of professional directors is being prepared is to be posted on the Federal Property Management Agency web-site. Nominations for independent directors can be put forth by Ministries, director associations, and through self-nomination. To participate in the competition for the selection of candidates for professional directors and the subsequent nomination and election to the JSCs with State participation, potential candidates must fill out a form and make a list of joint stock companies to which they propose their candidature. The Commission reviews whether the candidates have experience in the industry of the relevant SOEs and in the governing bodies of companies (the board of directors or supervisory board). The Commission also considers as relevant the experience in investment consulting. The results of these review process are published on the Rosimushchestvo website on the basis of the minutes of the Commission.

[36] Belova argues that the mission of independent directors should not be limited to just "attending" board meetings. Full commitment implies time and effort, therefore Belova argues that independent directors should be either people who do it as their main and only activity and thus can afford from 5 to 7 boards of directors, or those who are senior managers and can work in parallel with their main job on no more than 2-3 boards.

[37] See http://www.fcsm.ru/ru/legislation/documents/projects/index.php?id_3=367&year_3=2009&month_3=6

[38] Code of Corporate Conduct, Chapter III, Par. 4.7.2 and 4.7.3.

[39] Informed observers argue that these will have to be improved and hope that a bill of law now with the State Duma that may address these issues in an appropriate way. One of the issues that the bill of law also considers is the option of a dissenting board member to resign from the board, a possibility that does not exist pursuant to prevailing rules.

[40] The AEB report suggests that "those companies that have both the Revision Committee and an Audit Committee, consideration should be given to areas in which both bodies may be able to cooperate and collaborate. For those companies that only have a Revision Committee, it is recommended that they be empowered by the legislation with additional duties and responsibilities that would resemble the mandate of an Audit Committee elect the Revision Commission by cumulative voting." Moreover, it is reported that the *modus operandi* (an internal document laying out the functions and responsibilities of the revision commission that has to be approved by the shareholders meeting), in practice is approved only when the company is formed and remains unknown and rarely available to new shareholders or new board members thereafter.

[41] See the explanatory note to draft Federal Law No. 394587-5 amending some legislative acts of the Russian Federation with regard to the accountability of the management members in the companies.