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ISSUES IN CORPORATE GOVERNANCE AND DISCLOSURE IN RUSSIA

Presentation on by

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[1]Overview

The 1990s decade marked an abrupt acceleration in globalization trends, which underpinned economic and social processes in the world community, and globalization of investment processes proved to be one of them. Looking for the more profitable industries and instruments for their capitals, investors on a massive scale moved outside their national borders. By comparison with the earlier decades, they have multiplied their investments manifold, broadened their geography and tried new forms and mechanisms for the mobilization and use of capitals.

Owners of capital resources can now not just enter new markets but also exit should the business environment there deteriorate significantly.

Russia is a good example in this respect: despite all existing bars, annual rates of capital flight remain considerable.

The above factors have combined to create a major boost to the demand for investment resources and the growing competition for capitals between countries and corporations. In certain countries of Europe (e.g. France, Germany or Italy), where until recently in corporate financing equity capital remained secondary in important to bank capital, certain measures have been undertaken to offer new opportunities to outside investors, improve transparency of local companies and strengthen the positions of minority shareholders.

But the most significant boost to the competition for investments on the international capital market was given by the entry of those countries that used to stay at the periphery of or in total isolation from international investment processes.

Russia is a graphic example of a country where mass privatization in the 1990s created tens of thousands of rather big companies that urgently needed investment resources to survive and grow.

It is quite apparent now that mobilizing investments in the Russian economy is an absolute precondition for the economic growth in this country.

Given that, there appears to exist a good basis for the development and implementation of some common standards and rules that would allow potential investors to gain a complete and accurate picture of the companies' performance, managers and beneficial owners, effective mechanisms and modes of investment, so that they do not have to waste time or money to arrive at their investment decision.

More and more countries recently have been adopting international accounting standards (IAS) aiming to improve transparency of financial accounting in their companies so that investors do not have to struggle with all the difficulties of understanding national accounting standards. In 1998 they approved global investment standards in a set of recommended rules for investment institutions whose aim was to help investors rate the performance of such institutions and their services. The process that focused on improved transparency of businesses and implementation of clear and obvious common standards

[1] The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its member countries. This paper is subject to further revisions.

ensuring such transparency was partly realized through the elaboration and adoption of corporate governance guidelines.

There is a growing awareness in those countries that such rules that will be clear and acceptable to investors from different countries, provided national companies comply with them, would give an important advantage in the tough competition for capitals. In some countries there is an ever growing understanding that even without particular reliance on foreign investors, adherence to the effective principles of corporate governance would help improve confidence of local investors, and offer cheaper and more stable sources of capital.

Corporate governance has evolved into a key factor for the future market economy in Russia. Abuses by the management, owners and controlling shareholders violate the rights of both foreign and local investors. The absence of corporate governance best practices has proved detrimental to the investment climate in Russia and has been in fact one the reasons of the failure to raise investments so much needed in Russia to ensure sustainable economic growth.

Privatization in Russia was introduced from top down, while macroeconomic changes were conducted in the absence of proper microeconomic basis (where corporate governance is a key aspect). The core elements of the relationship between corporate owners and managers were not properly resolved in the course of privatization. What Russia gained as a result was a widely dispersed minority shareholding structure, and companies with very closely linked management and controlling shareholders.

What followed was a process of consolidation of control in Russian companies which is still going on. The process has been marked by numerous shareholder rights abuses caused by the attempts to obtain or reinforce control in the companies.

As a result, shareholders are being deprived of an opportunity to exercise such basic rights as participation in the management of the company, the right to be informed, entitlement to a share of profits of the company, etc.

From the point of view of any professional investor, corporate paper is one of the high-yield (and consequently high-risk) types of investment. Any investor on the local market should focus not only on the efficiency of the business pursued by the company selected for investment, or its market share, etc. but also take into account possible losses resulting from the management's incompetence or bad faith, and discount for a possibility to suffer as a result of deliberate policies aiming to prejudice outside shareholders.

Numerous abuses of the kind have dealt a serious blow to the reputation of Russian companies and the country as a whole and become a major obstacle to the investment needed to ensure sustainable economic growth.

One of the essential rights of a shareholder is the right to obtain adequate and accurate information about the company's business. It is the timely disclosure to the shareholders of a full set of information that is the precondition and guarantee of the proper exercise by the shareholders of their rights to participate in the decision-making bearing on the principal changes in the company.

Numerous cases of shareholder rights abuses stem from the failure to disclose information about the mechanisms that make certain shareholders eligible for a degree of control incommensurate with their share in the charter capital. Through lack of such disclosure the control over the company may be redistributed in violation of the pro rata principle, and some shareholders would have to bear an unreasonably higher burden of risk than others.

Russian joint-stock companies tend to rely on some rather sophisticated models of cross-shareholding, involving financial institutions and building up financial-industrial groups (FIGs). Additionally, shares in the company are often acquired via offshore vehicles.

The majority of Russian joint-stock companies have no transparent policies vis-a-vis remuneration of their directors and managers which are expected to lay down certain criteria for the assessment of the performance by the board and executive managers and offer them incentives to create long-term value to the company. There are no clear and sound rules determining the size of the remuneration, there are virtually no such incentive mechanisms as options or other compensation forms that depend on the success of the joint-stock company.

An important element of corporate governance is the obligation of the joint-stock company to disclose information.

The issue of due disclosure of corporate information is an issue of national significance, highlighted, inter alia, by the Address of the Russian President to the Federal Assembly of 8 July 2000 saying that "the government shall guarantee shareholders an access to the information about the activities of enterprises, and limit possibilities for the dilution of their capital or asset-stripping."

The Russian legislation prescribes a number of requirements on disclosures in the form of prospectuses, quarterly statements, disclosures of corporate events, affiliated persons, etc.

However, it still lacks requirements describing the scope of information to be disclosed in the annual statements published by joint-stock companies. In effect, they fail to disclose information on the type and amount of remuneration to the board directors and executive management, on the number of shares held by them or their affiliates.

Central to annual statements is the financial information, which is required to be confirmed by an outside auditor. At the same time, there are no transparent procedures for the selection of such outside auditor by the board of directors to be nominated at the general shareholders meeting for approval; nor are there any criteria for the election of the company's audit committee.

One of the more serious violations of the shareholder rights which has proved quite widespread in Russia is the insider dealing whereby managers pursue certain transactions in their own interests or that of their major shareholders benefiting from insider information.

Still another problem is seen in the lack of effective regulations governing corporate disclosure of the dividend policies in the company.

The FCSM believes that shareholders and potential investors must be informed of the company's dividend policies.

The company is obliged to provide its shareholders with an accurate and complete information of its intention to pay out the profits to shareholders, or its plans to reinvest the generated income in future growth or production processes.

Since, should the dividends be approved their payment becomes the obligation of the company and as such gives shareholders the right to claim relevant amounts, such shareholders should be absolutely clear about the procedures involved in dividend payoffs – how the money would be remitted and what the deadlines are.

The future of effective corporate governance in Russia would be dependent on such a system of disclosures which could ensure that shareholders are given all the information that is objectively useful to them.

Admittedly, one of the deficiencies in the existing disclosure regulation is that under the Federal Law on Securities Market certain required disclosures are meaningless.

Indeed, such disclosure instrument as prospectus should be intended for the publication of the information about the issuer in the event of public offering by such issuer for the mobilization of additional capital and new investors. However, the effective legislation is such that the obligation to register the prospectus is also created to the issuer in cases when a prospectus has no sense whatsoever.

Of particular note is the need to revise the data required to be disclosed under the effective legislation. While the information to be disclosed must be objectively useful and instrumental for the investor, on the one hand, the disclosures system, on the other, must not be overburdened by superfluous information whose sheer amount may potentially compel the issuer to either find loopholes in the effective regulations or abandon issuance plans.

Improving the system of disclosures on Russia's capital markets is becoming one of the more important elements of the national economic policies, and an important objective for the establishment of a consistent system of corporate governance.