

**OECD conference on  
“Corporate Governance in Russia”  
Moscow, 31 May - 2 June 1999**

**Synthesis Note**

**I. Summary and overview**

In the framework of its country programme for Russia, the OECD Centre for Cooperation with Non-Members (CCNM) organised a high-level experts meeting on “Corporate Governance in Russia”, which took place in Moscow on 31 May -2 June 1999. The meeting was jointly organised by the Russian Supreme Arbitrazh Court and the Federal Securities Commission with the co-sponsorship of the United States Agency for International Development (USAID) and the World Bank. Other key Russian governmental agencies such as the Ministry of State Property, Ministry of Economy and private sector institutions including, the National Association of Securities Market Participants (NAUFOR) and the Professional Association of Registrars, Transfer-Agencies and Depositories (PARTAD), were also actively involved.

The meeting successfully brought together senior government officials and policy makers, representatives of business and social partners, governance experts from OECD member countries, foreign investors as well as several international organisations. The discussion focused on the overall corporate governance landscape, the legal framework for corporate governance and its implementation, and the relationship between shareholders and enterprises in Russia.

The forum achieved its main objective, i.e. to raise the awareness of Russian officials responsible for the implementation of investor-protection legislation and the Russian corporate sector on the important role corporate governance plays in the future development of enterprises. The endorsement of the OECD Corporate Governance Principles at the OECD Ministerial a few days prior to the meeting reinforced the value of using the Principles to benchmark and gauge progress in this area. Participants agreed that there is scope for using the Principles as a template for reform. Foreign investors also took the opportunity to define the areas of concern, as regards corporate governance, from their perspective.

Participants considered the meeting to be valuable and of high quality. They particularly expressed their appreciation for the background papers, which generated a lively and frank discussion yielding important insights and conclusions on the corporate governance reform issues in Russia. Russian policymakers found the introduction to the OECD Corporate Governance Principles and the practical examples of the challenges faced by OECD countries as they reform their own corporate governance regimes particularly beneficial.

The forum also succeeded in identifying the future direction of the policy discussion on corporate governance in Russia, using the Principles as the main tool. In view of these first achievements, participants emphasised the importance of continuing the policy discussion on these issues in Russia and establishing a permanent dialogue between the private sector, regulators and foreign investors through the creation of a **“Corporate Governance Roundtable for Russia”**. This would help raise and maintain momentum for corporate governance reforms and ensure high quality advice for the public and private sector decision-makers involved in this effort.

While external developments have contributed to Russia’s economic hardship, it is now widely recognised that structural policy shortcomings in the investment process, including the lack of effective corporate governance mechanisms, have been an important factor. To be sure, many foreign investors exhibited little prudence in providing financing regardless of the opacity of corporate governance arrangements. However, there is a growing awareness that one of the vital conditions for investors to return to Russian companies is improving corporate governance mechanisms. Enterprises that have introduced transparency, accountability, and independence at the board level, have seen their wealth preserved and investors still willing to support them, despite the overall country/market risk. Thorough restructuring of the financial sector in the wake of the crisis might also represent an opportunity for a more transparent corporate governance structure and the establishment of an arms-length relationship between banks and corporations.

A number of recent corporate governance abuses generated intense discussion about the future shape of Russian enterprises in the coming years. Investors have often seen their shares diluted by insiders and major shareholders. Enterprises have been stripped of their assets by various means of transfer pricing and other related transactions. The interests of creditors have not been adequately protected. Poor corporate governance practices have hampered the mobilisation of outside capital and cultivated conflicts of interest. These weaknesses have been compounded by serious deficiencies in the tax and accounting systems as well as institutional structures.

Russia has achieved substantial progress in enacting essential economic legislation during a relatively short time-span, however important work remains to be done in order for better corporate governance to emerge:

- Strongly encourage competition, including reducing barriers to entry, promoting de-monopolisation and facilitating efficient market exit;
- Implement and enforce existing laws and regulations by strengthening the institutional capacity of the judiciary and regulatory authorities (mainly the Supreme Arbitrazh Court and the FSC) and deepen the understanding of the issues involved;
- Improve the business culture by raising awareness of these issues in Russian enterprises and building private institutions that will foster the development of business rules and ethics.
- Increasing the responsibility and role of the enterprises could encourage the development of an accountable and transparent corporate sector, an important prerequisite for a more open economy and society, with integrity and accountability at all levels.

The following Note attempts to summarise the important policy issues that were raised during the discussion and outlines a number of the main conclusions. It is drafted under the responsibility of the OECD Secretariat.

## **II. Main issues and conclusions**

OECD countries have taken major steps to improve corporate governance practices over the last decade. Some valuable lessons can be learned from these experiences. To begin with, it is critical to establish credible and enforceable provisions for property protection, secure methods of ownership registration and the opportunity to obtain effective legal redress. These are pre-requisites for the *mobilisation* of capital. At the second stage, reliable and transparent accounts are essential for making informed decisions about the *allocation* of financial resources among alternative uses. At the third stage, proper procedures for internal corporate decision-making, the distribution of authority among company organs, proper incentives and established lines of accountability are important for effective *monitoring*.

### ***Corporate Governance in Russia: The Changing Environment of Ownership and Control***

It goes without saying that Russia's corporate governance reform effort must inevitably take into account the specificity of the country, the legal and cultural traditions, and the underdeveloped market environment in which its companies operate. However, as capital markets are becoming global, it is important that Russian corporations apply some minimum standards of good corporate governance, in order to attract investment.

The corporate governance environment in Russia has been particularly fragmented. While the mass privatisation programme succeeded in transferring ownership of enterprises from public to private hands, ambiguous property rights resulted in an unstable ownership environment for the majority of Russian companies. This favoured insider/management control but did not create incentives for outside investment sorely needed by Russian corporations. Following mass privatisation, the loans-for-shares scheme resulted in transferring ownership in some of the largest, more important companies to a few well-placed Russian financial concerns, with little regard for transparency or a competitive process. Where outsiders were allowed to buy shares, the rights of the new minority shareholders were poorly protected. Furthermore, the lack of sufficiently developed institutions and the market mechanisms that would monitor enterprise performance hindered post-privatisation enterprise restructuring. As a result, efforts to improve corporate governance have developed at a slow and uneven pace.

The ownership and control environment has been significantly altered since the 1998 financial crisis. As a result of the weakened financial sector, banks, as shareholders cannot be expected to play an important role in leading the corporate restructuring effort, at least in the near future. Although the state remains a shareholder in a number of firms, its financial weakness and inability to exercise control has put in question both its role as a shareholder and as a credible source of financing. In contrast, foreign direct and portfolio investors who were largely absent as corporate governance principals in the past could play an important role in promoting good corporate governance. In the short term, enterprise insiders could also play a prominent role by taking responsibility for driving corporate restructuring. Their disposition could be changing from an essentially suspicious and contentious one to one that is more open to outside investment, as a sole means for survival of the enterprises.

### ***Ensuring Equitable Treatment of Shareholders and other Stakeholders***

Minority shareholders in Russia have often faced a range of abuses including asset stripping, transfer pricing, share dilution, restricted access to shareholder meetings and barring outside investors from taking seats on the board of directors. These practices are harmful to the development of enterprises and the attraction of outside investment.

Self-dealing transactions are common practice, in particular asset stripping. Transfer pricing is widely used by holding companies to transfer value away from their subsidiaries and outside investors to a holding structure. Profits usually end up with the management-controlled company. Although the equity market is on a downturn, new share issuance is on the rise. This is often the result of efforts to dilute holdings of minority investors. Companies frequently fail to comply with the laws that regulate share issuance such as adequate pre-notification for the exercise of pre-emptive rights. Obstruction of share registration is also prevalent. While independent certified registrars must maintain most share registers, some are still in the hands of the company's management. Therefore, minority shareholders seeking to assert their rights may be confronted with the company fighting back by manipulating the register.

In Russia, managers often undertake major strategic moves without the consent of shareholders. In order for shareholders to influence the decision-making process in a company, it is important that they can exercise their voting rights at the Annual General Meeting (AGM). In order to do so, shareholders need to be furnished with sufficient and timely information regarding the date, location and agenda of the general meetings. This presupposes a system, which allows the effective participation of the shareholder and the accurate representation of their views through the proxy mechanism. Enterprises should be encouraged to broaden participation by enlarging the use of modern technology, including telephone and electronic voting.

Another important instrument for ensuring equitable treatment of shareholders is the role of the board of directors. This tool has not yet been adequately exploited in most Russian companies where there is often blurred responsibility between management and the board. The board should be accountable to all of the company's shareholders, ensure the fair treatment of other stakeholders and corporate compliance with applicable laws and regulations. Companies should be encouraged to engage a sufficient number of independent non-executive board members where there is a potential for conflict of interest or where independent business judgement is advisable. Russian companies that have introduced this measure are seeing positive results, in terms of access to outside investment.

Much remains to be done in order to improve the implementation of the company law. Shareholders should be encouraged to use the legal remedies it offers to protect their rights and take grievances to the proper regulatory authorities. The Arbitrazh Courts should be assisted in building the infrastructure and expertise necessary for interpreting the law in an objective and efficient way. Furthermore, the FSC should be given the means to enforce the recently adopted Law for the Protection of Investors.

### ***Improving the Integrity of Markets by Promoting Better Corporate Governance and Effective Transparency***

The Russian market suffers from a considerable opacity of financial, ownership and corporate governance arrangements, especially in corporate groups. Experience in countries with large and active equity markets shows that disclosure has been a powerful tool both for influencing the behaviour of companies and for protecting investors. A strong disclosure regime is a key feature of market-based monitoring of companies and is central to shareholders' ability to exercise their voting rights. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to make informed decisions about the acquisition, ownership and

sale of shares. Disclosure has often proven to be more effective than detailed prescriptive rules. Through the specialised press and other reputable agents, it also helps improve public understanding of the structure, activities and policies of enterprises. Ultimately, enhanced transparency and disclosure can be expected to help the growth and deepening of financial markets, encourage the efficient use of capital and build confidence through predictability from which the whole society can benefit.

In Russia, the inadequacy of accounting rules and standards has impeded the development of an effective disclosure regime. The necessary reforms of accounting legislation have not yet been completed and the accounting rules issued by the Ministry of Finance are driven by tax considerations. Companies with international investment have the option to use international accounting standards while at the same time preparing accounts according to Russian rules, but smaller companies cannot afford such a dual accounting option.

In addition to financial disclosure, transparency of ownership arrangements must be enhanced. Too often, shareholders disguise their ownership by buying shares through one or more offshore shell-company not traceably connected to the beneficial owner. This undermines the effectiveness of rules on interested party transactions, insider dealing, conflicts of interest and anti-monopoly policies.

The FSC has a fundamental role in ensuring effective transparency and disclosure as the securities market regulator. In the past, its power was limited by lack of legal and administrative enforcement tools. The recently enacted law on the protection of investors' rights is expected to give the FSC more leverage in this regard, such as new fines and sanctions for violations. The law affects all market participants including issuers, intermediaries, investors and regulators. This legislation is viewed as a welcome sign that the Russian authorities are taking steps to minimise foreign investor risk. Self-regulatory associations, such as NAUFOR and PARTAD, are expected to play a prominent role in developing business ethics in their area, while efforts to set standards by accounting/auditing professional bodies will also be very important.

### ***Corporate Governance Practices in Russian Enterprises***

The discussion on the legal instruments underpinning the corporate governance environment in Russia revealed that on the whole, they are quite good. However, the adoption of corporate governance rules in itself is not enough to substantially improve the performance of Russian enterprises. There is a great need to enhance the infrastructure in order to encourage effective implementation and enforcement of these rules. In this regard, it is important to sustain the emergence of a set of intermediary market institutions to help keep shareholders informed and assist them in exercising their control rights. A lot can also be done at the voluntary level, including the continuing education of corporate managers to lead the behavioural change at the enterprise level, without which reforms may not become effective.

Most importantly, Russian enterprises should realise that better corporate governance serves their own self-interest. To attract financing, enterprises have to produce some value to outside investors, ensure transparency of their financial management and, most importantly, relinquish some of their control over corporate decision-making. In this regard, a strong partnership between shareholders and stakeholders (managers and employees) in companies could be an important force of change.

Case studies on Norilsk Nickel and United Energy Systems demonstrated the forces driving corporate governance reform at the enterprise level. Corporate decisions are increasingly driven by the need to access financing in international markets. Treatment of shareholders and other stakeholders directly impacts on their capacity to survive and prosper in the global marketplace. In this regard, the financial crisis has been a catalyst. As liquidity started to dry out, enterprises became confronted with the realities of market forces and the importance of building a strong corporate governance framework. Managers are starting to appreciate the value of establishing closer dialogue with shareholders. Some large Russian companies have created investor relations departments and even introduced corporate governance charters. However, much remains to be done to improve the channels of communication with minority owners.

The discussion on foreign investors' expectations highlighted some of the obstacles to foreign investment and generated some recommendations on how to meet these challenges. Weak corporate governance has emerged as the most serious impediment to foreign investment in Russia. Not only does it drive investors away from specific

Russian corporations, it also perpetuates negative dynamics for the whole Russian corporate sector and thus deprives even transparent and honest enterprises from getting investment. Investors are particularly concerned with disclosure and transparency issues, such as the reluctance of some Russian firms to provide adequate financial, operating and strategic information. Foreign investors are also distressed by lack of equal treatment of foreign and domestic shareholders by courts and local authorities. In this respect corruption is a major impediment.

A collective effort to introduce a code of ethics, driven by professional associations, major companies and investor groups would be important. This could complement efforts at the regulatory and enforcement level as well as help the emergence of a culture of compliance and disclosure. As participants pointed out, such an effort could be based on the OECD Principles of Corporate Governance.

### ***The Role of the State as a Shareholder***

The Ministry of State Property remains a majority shareholder in over 12,000 state-owned-enterprises and a minority shareholder in over 3,800 companies with no coherent set of goals to exercise its ownership rights. Assets are managed mostly via state boards composed of 2,000 members of ministries and agencies. Co-ordination between them is poor and their powers are ill defined.

Using privatisation as a tool for improving corporate governance and creating better capital markets has met with success in many countries, including emerging and transition economies. In Russia, privatisation has not yielded entirely satisfactory results due to the lack of a transparent and competitive process. The success of future privatisation efforts will depend on their openness and competitiveness. Moreover, in the wake of the financial crisis, privatisation may be used as a tool to introduce foreign investment and broaden capital markets.

Another concern is the current trend to re-emphasise state control over private incentives in corporate governance and re-politicise property management by shifting responsibility over ownership rights from the Ministry of State Property to the line ministries. This is likely to further blur the lines of accountability. It is important to distinguish between the role of the state as a regulator and a shareholder. As the regulator, the state should address the public interest concerns in natural monopolies and infrastructure sectors. Specific institutions should fulfil these functions. These should be different from state agencies holding and managing shares of state-owned-enterprises.