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*REVIEW OF CORPORATE GOVERNANCE TRENDS IN RUSSIA, CURRENT PRIORITIES AND FUTURE OUTLOOKS

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* 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.

INTRODUCTION

1. The latest developments connected with the bankruptcy of major companies and the entailing reevaluation of principles of regulating the corporate governance system in the United States and Europe have not had a strong effect on corporate governance in the Russian companies. However, these events have undoubtedly made the Russian government and the business community review the situation very closely, analyze the current policy of the government and companies in such sphere as the corporate governance standards, including control, responsibility and information disclosure standards.

2. It is important for the government to acknowledge the role of joint stock companies' information disclosure standards, and standards of corporate governance in general, as well as their enforcement practices. The last positive tendencies in development of the Russian corporate sector and stock market made the questions of development of corporate government extremely actual. The government became an initiator of the reform in the corporate government with active support of foreign investors. It was connected in many respects with a fact, that the notion itself and the rules of the "correct corporate behaviour" were absolutely new for our companies, so they could not be fully adopted on the initial stage.

3. However the development Russian model of corporate government "from the head" had not only positive effects (popularisation of the idea of "good corporate behaviour", adoption of the corporate behaviour Code in 2001), but also the negative ones. First of all, it was bound up with the motivation of state agencies, which were aimed at the creation of the transparent system of open information on the Russian companies, creation of the control system of violations on the stock market along with the reservation and enlargement of their power. Such an aspiration of the state agencies for a control of market lead to the appearance of substantial transaction costs for companies.

4. Today it is very important to recognize the priority steps to be taken for elevating the transparency level of the Russian companies. There is the option of strict governmental regulation and control and the tightening of obligatory standards, and it is also possible to embark upon the way of development of the institution of self-regulation with the development of standards on the level of professional participants in the securities market. There is still much debate about the financial accounting standards themselves and their practical employment. There is no distinct answer to the question of obligatory disclosure of non-financial information by joint stock companies, such as data relating to the observance of the Code of Corporate Conduct. The existence of a large number of outstanding issues substantiates the acuteness of surveys aimed at reviewing the reasons of the high degree of non-transparency of the Russian companies.

5. This analytic report sums up the results of a number of surveys demonstrating that the corporate sector of the Russian economic is represented by many open joint stock companies – around 60,000, only 200 of which place their shares at stock exchanges. The problem of manipulating corporate reporting data has always been connected with a possibility of artificial overpricing of exchange value of shares circulating on open market. Therefore in Russia, the problem of information disclosure has its own specific features, considering the number of issuers represented on the stock market.

6. The analytic report also shows that most joint stock companies do not pursue the goal of entering the stock market and attracting external investors not affiliated to the company management or the major shareholder. It is not an easy task to evaluate the reasons behind such conduct, but we can highlight two significant factors. Firstly, most joint stock companies were created "artificially" in the process of privatization, and the choice of this particular form of business was caused by restrictions set by the law on privatization. Secondly, a weak judicial system and a high level of corruption lead to high risks of violation or even total loss of title to shares if their fraction does not secure a shareholder's full control in the joint stock company. This problem is considered in detail in section 6 devoted to the judicial reform.

7. These factors result in a predominantly high concentration of joint capital in the hands of one shareholder or a group of related parties.

8. Under these circumstances, the objective of ensuring the openness of joint stock companies cannot be achieved only by tightening mandatory information disclosure requirements. A flexible approach is needed to outline precisely public companies from the entire range of joint stock companies, and apply stricter requirements and sanctions to them. This principle should be taken into account during the development of the law on affiliates, on insider information, and while introducing other amendments to the law dealing with information disclosure.

9. Considering that the stock market so far is not the main institution ensuring redistribution of capital between economic sectors and spheres, such mechanisms as mergers, divisions, transformations, and other forms of reorganization, as well as the acquisition of major blocks of shares (takeovers) play an important role in the companies' practice. The analytic report shows that the employment of these institutions involves high risks and costs, above all due to insufficient legal regulation. The level of protection of shareholders' rights during the employment of these mechanisms is rather low, which concerns, among other things, insufficient information disclosure requirements to shareholders of reorganized companies.

10. On the whole, considering the shortage of internal investment resources of the Russian companies, restricted opportunities of the banking system, as well as favorable macroeconomic prerequisites for investment growth, it is possible to forecast an increase in the number of public companies oriented on attracting joint capital from an unlimited range of investors. Consequently, the demand for high corporate governance standards in the Russian companies, an effective system of government regulation of the activity of issuers and professional market participants, and an efficient system of legal protection of shareholders and investors, will grow.

1. POSITIVE PREREQUISITES AND CONDITIONS FOR DEVELOPMENT OF CORPORATE GOVERNANCE IN RUSSIA IN 2001-2003

Economic and political incentives for direct investment growth already exist. Much depends on institutional conditions and readiness of companies now.

11. According to the data of the Russian Ministry for Economic Development (Minekonomrazvitia) and Goskomstat, the development of the investment sphere in the 1st half of 2003 was characterized with a considerable **growth** in investment activity compared to 2002. In January-June 2003, investment in fixed assets grew 11.9% over the same period last year (compared to a mere 2.5 percent in 2002). In the period from 1 January 2001 to 1 January 2002 investment increase totaled approximately 7%.

12. Investment activity on results of 2003 is expected to grow at a much faster pace than the fixed assets investment dynamics in 2002, although slower than in January-June 2003. The volumes of investment in fixed assets are also expected to continue growing in 2004-2006. The greatest positive effect of the liberalization of the tax regime with respect to the pace of fixed assets investment growth is anticipated in 2005-2006.

13. There are also forecasts of an increase in foreign investment inflow in connection with the work underway to improve the investment climate in Russia (**table 1** of the Annex).

14. The continuing macroeconomic stability has a positive effect on foreign investors' sentiment. Starting 1999, the overall predictability of the economic situation in Russia in the coming years has increased. Real strengthening of the ruble will make a certain contribution in drawing foreign investment, particularly portfolio investment, to the Russian national economy.

15. Russia's increased international country ratings also play a positive role in drawing direct foreign investment.

2. MAIN TRENDS IN EMPLOYING CORPORATE GOVERNANCE PRINCIPLES AND STANDARDS

High corporate governance standards are becoming a necessary condition for development of a company and business in general. But most companies are not ready for their enforcement.

16. The improvement of the economic situation in 2001-2003 and positive direct investment dynamics forecasts for the period up to 2006 are the factors that may lead to enhanced demand for high corporate governance standards in the Russian companies, effective system of government regulation of the activity of issuers and professional securities market actors, efficient system of legal protection of shareholders and investors.

17. Following the 2001 Round Table, the Russian Federation Government has developed and approved the Code of Corporate Conduct presenting the high corporate governance standards (requirements) accepted in world practice.

18. A number of surveys show that so far only a very limited number of issuers apply these standards. The extension of the practice of applying the corporate governance standards inherent in the Code cannot be qualified as a tendency. This concerns issues of information disclosure, activity of the board of directors, the shareholders meeting, internal audit, and some other key elements. According to the data of IFC and IDA[1], 47% of companies are familiar with the provisions of the Code, only a third of which have enforced them. The Code chapters The Board of Directors (62%) and General Shareholders Meeting (53%) are employed more often, and Information Disclosure (43%) less frequently. The survey covered 307 representing various industries in 4 largest Russian regions, each having over 50 shareholders.

19. Why is this happening? First of all, it should be mentioned that most joint stock companies are still **not interested in attracting investment** by selling stocks to eternal investors and the bulk of JSCs are in fact private non-public companies.

20. According to the information of the Investor Protection Association (hereinafter – API)[2], just a few companies sell their shares to external shareholders, not affiliated with the controlling proprietor. Just a few respondents said they sold stocks to small shareholders (4% of the polled companies). Direct foreign investment entailing changes in corporate control is attracted by 11% of the sample (a total of 400 large and medium companies representing 76 regions were covered by the survey). As a rule, the largest shareholder is a person affiliated with the holder of the controlling block of shares.

21. Nevertheless, there is also an opposite tendency in the companies' expectations. For example, 46% of enterprises covered by the poll would like to attract the investments from small shareholders and 7% - large shareholders.

22. Orientation on equity investment funding is backed by statistic data as well. For many years now, the share of external investment into fixed assets in the economy has not raised above a 50 percent margin. This is not so little, but the attracted funds mainly consist of resources of budgets and extra-budgetary foundations. The share of bank loans remains insignificant – less than 5% of investment. A substantial role belongs to loans from other companies, including parent organizations of holdings to their subsidiaries, and partner investments. The share of investment into the economy from abroad does not exceed 5-6% (in 1995-1997 it was 1%).

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[1] The survey of the practice of corporate governance in Russian regions was prepared by IRG on request of IFC and IDA in 2003.

[2] Report on the activity of the Investor Protection Association on grant M02-0440 of the Eurasia Foundation. Project "Promoting the Improvement of the Corporate Governance Practice in Russian Companies"

23. The proportion of equity funding in industry is much higher than in the economy in general, but starting 1998 it has been steadily decreasing. The share of all budgets is less than 4%.

24. The share of financing investment in fixed assets in the economy by stock issuance did not rise above 0.7% over the past 5-6 years. This level is very low. Statistic survey over the contribution resulting from corporate stock issuance has been conducted since 2003 (**diagram 1** in the Annex).

25. On the whole, this situation demonstrates, besides excessive government participation in the economy, the companies' conscious preference of such source of financing as equity funds. The system of self-financing and/or partner financing is logically linked with the orientation on the companies' being closed to external investors, nonpayment of dividends and non-transparency of property. The small proportion of bank financing can be most probably explained by high creditor risks in the Russian economy.

26. High concentration of property is another feature attesting to reluctance to share corporate control. According to data of an empirical study based on a poll of over 300 open joint stock companies conducted by HSE (GU) in the autumn of 2002, more than 70% of respondents (76% in industry) believe that a controlling shareholder has formed at their company. The 2002 CEFIR and IET survey (over 600 industrial JSCs responded to questions concerning property) has demonstrated that the average share of the largest external shareholder in the sample is some 24%, and that of the company administration – over 19%.

27. It is rather difficult to evaluate the level of influence of the shareholder capital concentration on the quality of corporate governance. For example, the survey conducted by the Center for Economic and Financial Research and Development shows that the more shares are at the disposal of the administration and major external shareholder, the better is the quality of corporate governance. However, property concentration makes a favorable effect on corporate governance only until it reaches a 50 percent margin, after which this effect becomes insignificant.

3. INFORMATION DISCLOSURE

Far from all joint stock companies observe obligatory information disclosure requirements. The main reason is that the bulk of Russian companies are not public and so far do not pursue such objectives

28. The evaluation of companies' transparency is very important for rating the quality of corporate governance. Companies' non-transparency received the most negative investors' evaluation during the development of the corporate governance rating methodology of Brunswick UBS Warburg – 14 points out of the possible 14 (the highest point is given to factors whose influence on the quality of corporate governance, in investors' opinion, is the greatest).

29. Information disclosure requirements in Russia are set by the laws on joint stock companies, on the securities market, and accounting, as well as various regulations of governmental authorities. The latest changes in the information disclosure regulatory framework include the new Standards of securities issues and registration of securities issue prospectuses by the Russian FCSM adopted in 2003[3]. Compared to the former Standards of stock issue during the establishment of joint stock companies, additional shares, bonds and their issue prospectuses, the new rules specify the procedures for registering bond issues.

30. These Issue Standards set additional requirements to presenting documents to registering bodies during the issue of secured bonds and registering secured bonds issue prospectuses. In particular, they specify the requirements to

[3] Resolution of the Federal Commission for the Securities Market of 18 June 2003, No.03-30/ps

reports upon the results of issues of secured bonds. Additional requirements are introduced to the contents of the secured bonds issue decision. Additional regulations require state registration of mortgage-secured bonds issues and reports on results of their issues.

31. The new rules stipulate the particularities of issues of bonds placed in tranches and introduce new procedures for notifying of the changes in the data on securities issue, the issuer and/or person securing the bonds, following state registration of the report on results of the issue (additional issue) of securities.

32. Amendments were introduced to the Federal Law "On the Securities Market" 2002, setting new requirements to information disclosure by the issuers. The Law envisages more detailed issue prospectuses. Similar more detailed requirements are set to the issuers' quarterly reports.

33. The new Law also stipulates that the issue prospectus shall be registered during the placement of securities or later, when the issuer decides to place its securities for public offering. This approach is more flexible. It opens up the opportunity for private offering of securities that does not require information disclosure, and when the issuer has developed enough and need to enter the open market – registering the issue prospectus thus allowing broad circulation of securities issued earlier. In connection with these changes, the issue prospectus shall be renamed as the securities prospectus.

34. The issue prospectus shall be registered during the placement of underwritten securities among an unlimited number of holders or the circle of owners known in advance if their number is over 500, and also if the overall issue volume exceeds 50,000 minimal salaries.

35. The Law stipulates that in cases when at least one issue of the issuer's underwritten securities was accompanied with the registration of an issue prospectus the issuer shall disclose information on its securities and its financial and business activity in the forms of:

- quarterly issuer's reports;
- notices of major facts influencing the issuer's financial and business activity.

36. The weakness of this approach to setting criteria is that a multitude of rather "small" companies are compelled to present quarterly reports and disclose major facts even in the event of private offering of their shares. It seems more expedient to present quarterly reports in connection with registration of securities issues with the Russian FCSM and public offering of stocks rather than with registration of issue prospectuses. This would make the circle of joint stock companies covered by the issue prospectus regime narrower (it would include open joint stock companies issuing stocks for public offering among an unlimited number of persons).

37. The new law requires that the prospectus shall be signed by a financial adviser independent from the issuer. The law stipulates that having signed the prospectus the financial adviser assumes the responsibility for the completeness and reliability of its contents together with other signatories of the prospectus (manager, chief accountant, auditor, etc.). The role of the financial adviser is similar to that of an auditor whose participation in the preparation of the securities issue prospectus is also obligatory, but unlike the auditor, the task of the financial adviser is to confirm the reliability of non-financial information presented in the prospectus.

38. The participation of a financial adviser is obligatory only in the event of public offering and circulation of securities. If securities are placed for private offering, it is up to the issuer to decide whether to attract a financial adviser or not.

39. In our opinion, however, isolating consultative services to stock issuers as an independent form of activity leads to unjustified reduction of the range of persons presently rendering such advisory services (law firms, auditors, registrars).

40. Provisions on information disclosure on observance of the principles of the Code of Corporate Conduct require special consideration.

41. The Russian FCSM acts[4] stipulate that a company's annual report, subject to approval of the general shareholders meeting, shall contain information on observance of the Code of Corporate Conduct by the company. At the same time, this requirement was introduced without examining investors' and other stakeholders' actual need for such information. Meanwhile, regular reports on the observance of the Code provisions required additional expenses by the issuer. This act covers annual and extraordinary general shareholders meetings of closed and open joint stock companies (hereinafter – the companies) held in the form of sessions (joint presence of shareholders for discussion of items on the agenda and adoption of decision on issues put up for vote) or vote in absentia. The majority of companies to which this requirement applies are not public entities. Therefore a more thorough analysis of expedience of such requirements is necessary.

42. Although the law sets rather strict requirements to information disclosure, data of surveys demonstrate that the practice in this sphere remains unfavorable[5]. This is confirmed, in particular, by API studies. Type 1 on diagram 2 presents information on the structure of shareholders of over 1% of the voting shares; type 2 – information on shares owned by members of the board of directors; type 3 – data on the existence of affiliation between holders of blocks of shares whose aggregate volume exceeds 20% of the charter capital; type 4 – information on persons affiliated with members of the Executive Board and the board of directors – upon results of a survey of over 400 medium and large companies.

43. Diagram 2 in the Annex shows that 57% of joint stock companies do not disclose information on the structure of shareholders of over 1% of the voting shares, not more than 71% of the companies disclose information on the existence of affiliation between holders of blocks of shares whose aggregate volume exceeds 20% of the charter capital, and 75% disclose information of the polled companies disclose information on persons affiliated with members of the Executive Board and the board of directors.

44. According to data obtained within the project "Development of Demand for Corporate Governance Regulation in the Private Sector,"[6] the Russian companies' demand for the IFRS mechanisms is rather low, too.

45. According to the returns of the survey of over 304 large and medium companies, less than 13% of the companies employ IFRS principles in their reporting, while not more than 11% of the sample consider themselves ready to switch over to IFRS. As a matter of fact, there is an obvious connection between the company's financial standing and its readiness to adopt IFRS: 75% of successful OJSCs are prepared for this transition. Therefore, it would be a more logical step to begin the transfer to IFRS from large business entities and the financial sector, and gradually make these principles obligatory for other groups of companies as experience in this sphere grows.

46. The following reasons can explain the low level of information disclosure and poor enforcement of the law in this sphere:

- disinterest of more Russian joint stock companies in attracting external investors;
- lack of legislation on protection of commercial secret;
- incorrect definition of the distinction between public and nonpublic joint stock companies by effective law.

47. It is our opinion that the low level of observance of numerous information disclosure requirements by companies is connected with the fact that these requirements, set for the purpose of protecting the rights and interests of a wide range of investors, also apply to the companies oriented on promoting investment on the stock market and should not be subject to such regulation.

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[4] Resolution of the Federal Commission for the Securities Market of 31 May 2002, No.17/ps "On Approval of the Regulation on Additional Requirements to the Order of Preparing, Convening, and Holding the General Shareholders Meeting"

[5] Report on the activity of the Investor Protection Association on grant M02-0440 of the Eurasia Foundation. Project "Promoting the Improvement of the Corporate Governance Practice in Russian Companies"

[6] Development of Demand for Corporate Governance Regulation in the Private Sector, autonomous nonprofit organization Projects for the Future: Scientific and Educational Technologies, Moscow, 2003.

48. Therefore the next step in the sphere of information disclosure should be the defining of the range of companies covered by the information disclosure regulations ("public companies") and those that shall not disclose information in such volume ("private, closed companies"). The main criteria for referring companies to some or other group should be the number of shareholders and the stock placement method.

49. The Government is currently discussing the draft law **On Insider Information** considered by the Russian Federation State Duma. The draft law establishes the responsibilities of government agencies in using insider information and regulates the rights and obligations of market participants and self-regulated organizations within this system. The development of this draft law was necessitated by a practically total lack of legal regulation in the sphere of using insider information and price manipulation on the securities market.

50. The main problems in discussing this draft law are:

- determining the circle of joint stock companies with respect to which tight requirements of insider information usage and relevant penalty measures should be applied;

- defining the key notions of "insider information" and "insider."

51. The table in the Annex compares the approaches to regulating the use of insider information stipulated by the draft law and employed by European countries (see Annex **table 2**).

52. At the end of 2002, the shares of not more than 200 issuers circulated on the Russian securities market. This means that for a time being the coverage of the draft law will be restricted to these companies. It is also unknown what approximate number of transactions involves the use of insider information and what is their effect on development of the Russian stocks market. Considering the poor stock market infrastructure, the list of information on major facts outlined by the law on the securities market seems quite sufficient for exercising the necessary current control over the use of insider information.

53. The Russian Ministry for Economic Development has also prepared a draft law on disclosure of **information on dividends.**

54. The order of adopting and announcing decisions on dividends established by the law on joint stock companies strips investors of the opportunity to purchase and sell stocks, having the information on dividends due on them in advance. As per the Federal Law "On Joint Stock Companies" the official decision on the size of annual dividends shall be adopted and announced only at the annual general shareholders meeting, which is, as a rule, 1.5 – 2 months after the date of drawing up the list of shareholders eligible to dividend. In some countries such issuers' activities are qualified as price manipulation on the stock market and use of insider information.

55. Under these circumstances, for instance, during the announcement and payment of dividends, the Russian corporations with respects to whose shares depositary receipts have been issued and depositors issuing depositary receipts with respects to one and the same shares have to follow contradictory requirements of the Russian and foreign law on the order of announcing dividends and fixing the lists of persons eligible to dividend.

56. Moreover, shareholders are not empowered to increase the size of dividends while they are usually not interested in decreasing the size of dividends paid to them. Consequently, the situation shaping out in practice is such that the shareholders approve the size of dividends recommended by the board of directors (supervisory board) without the authority to make any changes, which puts in question the need for such approval.

57. The need to hold an extraordinary general shareholders meeting if a decision is made to pay additional dividends noticeably increases joint stock companies' expenses and restricts their possibilities to pay dividends on a regular basis. Real opportunity to pay interim dividends remains only for joint stock companies with a small number of shareholders that do not pay dividends on a regular basis. All this serves to undermine the effectiveness of the dividend policy and creates real danger of manipulation of stock prices.

58. In order to eliminate the above flaws, it is necessary to authorize the board of directors to take decisions on the payment of dividends the size of dividends and form of their payment on each category (type) of stocks. This would enable to exercise in full measure the shareholders' rights to receive economically justified dividends, as members of the board of directors have the necessary competence and all relevant information on the company's economic status.

59. Work on the draft Federal Law "On Affiliates" was continued in 2001-2002. The notion of affiliates is one of the basic ones in Russian company law. Companies' relationships with affiliates and information disclosure on them have a strong impact on the level of corporate governance. It is particularly important to take affiliate relationships into consideration in the event of carrying out related party transactions, major deals, and corporate takeovers.

60. Several laws have provisions on affiliates. It was first mentioned in RSFSR Law No.948-1 of 22 March 1991 "On Competition and Restriction of Monopolistic Activity on Product Markets" (hereinafter the Law on Competition). The Law was further amended, including its provisions on affiliates. After the 1998 amendments, the Law on Competition defines affiliates as natural and legal persons capable of influencing the activity of natural and legal persons exercising entrepreneurial activity. The Law specifies the features according to which a person can be referred to affiliates (the basic indication is its belonging to a group of persons).

61. However, the notion of affiliate is more important for the purpose of corporate law. It is used in the Federal Laws "On Joint Stock Companies" and "On Limited Liability Companies."

62. The law on joint stock companies requires affiliates to notify the company in writing of the company shares in their possession, specifying their number and categories (types) not later than 10 days after the date of purchasing the said shares. If the failure to present this information or its untimely presentation through the fault of the affiliate results in damage to the company's property, the affiliate shall bear liability to the company in the amount of the inflicted damage. The company shall keep account of its affiliates and report on them in compliance with the requirements of Russian Federation law.

63. The order of accounting and reporting on affiliates is regulated by the Statute of Accounting "Information on Affiliates" (PBU 11/2000) approved by Order of the RF Finance Ministry No.5n of 13 January 2001, and by FCSM regulations. These data are entered in the note to companies' annual reporting. In addition, FCSM Resolution No.03-19/ps of 1 April 2003 entered into force on 25 May 2003. The basic innovation of this new regulation was the narrowing of the circle of joint stock companies covered by its requirements to open joint stock companies only, more detailed requirements for public information disclosure in the Internet (the issuer can now decide in which form – paper or electronic – to present information on affiliates to the registering authority). However, information disclosure requirements to OJSCs have been expanded. Before the new procedure was introduced, only OJSCs placing their newly issued securities for public offering and companies whose issues are registered by the Russian FCSM had to disclose information on affiliates on a quarterly basis. As per the new FCSM Resolution, all OJSCs shall disclose the list of affiliates within 45 days after the end of reporting quarter.

64. However, despite the changes introduced over the past several years, there are still a number of flaws in the law on affiliates.

65. The definition of affiliates given by the law does not cover all the possible grounds for affiliation, information disclosure requirements set to affiliates are rather indefinite, no responsibility of the market actors is stipulated for the violation of requirements of disclosing this information, etc.

66. Some criteria of affiliation stipulated by the antimonopoly law are inaccurate and intersect with other grounds for affiliation. Specifically, the Law on Competition envisages such affiliation criterion as participation in financial industrial groups (hereinafter –FIG). Officially registered FIGs are often created to gain government support or trademark promotion, and participation in a FIG is far from always an indication of affiliation. Moreover, practically any FIG can be described as a group of persons in the event of existence of certain property, managerial and financial relations between its participants, which results in the intersection of notions in the Law on Competition.

67. All this creates additional practical complications for companies during the determination of their affiliates, disclosure of information to regulators, and also signifies a lack of efficient influence mechanisms in the event of violation of the law.

68. In view of the aforementioned problems, a draft Federal Law “On Affiliates” was developed in 2000.

69. The draft law changes and simplifies the definition of affiliates:

- It suggests moving away from the definition of affiliation through the notion of a group of persons, as it is done in the competition law. This would make it possible to avoid the imprecise formulations used in the definition of a group of persons.

- The draft law on the whole proposes more strict criteria of affiliation: it lowers the “margin” for referring persons to affiliates from over 50% of a legal entity’s votes to 20%, expands the range of affiliates, specifically, including members of control and supervisory bodies.

70. The draft law introduces new requirements to accounting, disclosing and presenting information on affiliates:

- all legal entities shall keep records of affiliates and relevant information on them;

- joint stock companies obliged to disclose information in accordance with the law on the stock market must disclose the list of their affiliates in their annual reports. Any changes in the said list shall also be disclosed in keeping with procedure for information disclosure on major events. If affiliation relations exist between several legal entities they may assign relevant information disclosure to one of these entities;

- persons affiliated to a legal entity shall submit information on this affiliation within 7 days from the moment they have learned about it or should have learned about it;

- the range of cases and persons obliged to notify the joint stock company of their affiliates is expanded compared to Art.80 of the Law;

- a person affiliated to a joint stock company obliged to disclose information in accordance with the law on the stock market, shall notify the Russian FCSM thereof and shall present information on its affiliates within 3 days from the moment they have learned about it or should have learned about it. Shareholders who have failed to present this information shall not be entered in the list of persons eligible to participate in the general shareholders meeting.

71. The draft law leaves some open questions, in particular, it has not been decided which government authority will regulate legal entities that are not joint stock companies, the notions of indirect influence and its calculation have not been properly defined. However, the adoption of this draft law should be regarded as a positive event.

72. The problem of **ostensible shareholding** has been an object of active discussion lately. The notion of ostensible holder of securities is defined in item 2 Art.8 of the Federal Law “On the Stock Market.” According to this law, an ostensible holder of securities is a person registered within the registry system, including a depositor of a depositary institution, but which is not the owner of the securities in question.

73. This article also presents a list of persons who could be ostensible holders of securities, the order of their registration as ostensible shareholders and their responsibilities. The article of the law stipulates the duties of an ostensible holder of securities. The Federal Law “On the Stock Market” also contains provisions on the responsibility of ostensible shareholders.

74. The Federal Law “On Joint Stock Companies” establishes the duty of an ostensible shareholder to disclose information on persons in whose interests he holds the shares in question during the drawing up of lists of persons eligible to dividends and the lists of persons enjoying a pre-emptive right to securities convertible in stocks. In addition, this law also regulates the order of notifying ostensible shareholders of scheduled general shareholders meetings and the order of conveying this information to their clients. The Federal Law “On Investment Funds” introduces special provisions regulating the activity of ostensible shareholders, which are depositaries.

75. Moreover, the process of exercising the functions of ostensible shareholder by professional participants in the securities market is regulated by RF FCSM letter No.IB-09/2176 of 26 April 1999. This letter stipulates that the functions of ostensible shareholder can be discharged by professional participants in the securities market duly authorized with a license to a right to exercise depositary activities.

76. The order of termination of discharging the functions of an ostensible securities holder is regulated by a provision approved by RF FCSM Resolution No.46 of 10 November 1998.

77. In 2001, amendments were introduced in the Federal Law "On Joint Stock Companies," including new rules concerning the list of persons enjoying a pre-emptive right to securities convertible in stocks. Ostensible shareholders were obliged to present data on the persons in whose favor they hold the securities in question for purposes of drawing up such lists. The order of notifying ostensible shareholders of scheduled general shareholders meetings and conveying this information to their clients has also been specified.

78. Today the sphere relating to the activity of ostensible shareholders is facing the problem of lack of information on the owners of securities.

79. It is necessary to introduce a universal requirement for information disclosure on the owners of securities at all stages of securities issue and negotiation. In particular, it is advisable to oblige the issuer to disclose information on the owners of twenty and more percent of issued securities of *various types, sorts and categories.* This margin is chosen because it is presently the criterion for determining persons' affiliation and interest. Besides that, it is necessary to specify the rights, duties and responsibilities of various persons, including the issuers and owners of securities, in the process of gathering and disclosing information on the owners of securities, including the responsibility of the owners of securities for reliability, completeness, and timeliness of the data submitted by them to the issuer or its authorized person.

80. The Government is actively working on the elaboration of the Concept for Development of Accounting and Reporting in the Russian Federation for a mid-term perspective.

81. Until recently, issues of upgrading the financial reporting system were a focus of interest exclusively of government authorities, whereas during the past several years representatives of the professional community, institutional investors, shareholders, and nonprofit organizations have been actively jointing in the process of improvement of the system of financial reports.

82. The current system of regulating financial reporting in Russia is characterized with state monopoly on establishing accounting and reporting rules.

83. Requirements to accounting and reflecting business transactions in reporting (19 provisions on accounting, methodological recommendations, memos on employment procedures, etc.) are set by the Russian Finance Ministry.

84. The accounting and reporting rules for credit organizations are established by the RF Central Bank. Accounting and reporting requirements to insurance companies and nongovernmental pension funds are set, accordingly, by the Russian Finance Ministry's Department for Regulating Insurance Activity and the Russian Labor Ministry.

85. The Interdepartmental Commission for Accounting Reform including representatives of the government authorities and the professional community occupies a special place within the system of accounting regulation. The Interdepartmental Commission is responsible for working out proposals covering different areas of accounting reform, preparing draft regulatory acts for consideration by the Russian Federation Government. At the same time, MVK is not empowered with concrete responsibilities connected with the elaboration and approval of accounting standards.

86. The principal form of exercising control over financial reporting is compulsory audit of reports of organizations meeting certain criteria (amount of revenue, balance sheet value, form of incorporation, form of activity), required by the law on accounting and the law on auditing. So far, these requirements cover only the audit of legal entities' reports – no audit requirements are set with respect to consolidated reports, including those based on IFRS.

87. One of the main contradictions of the existing system is excess regulation of the process of development and adoption of regulatory acts on accounting in the absence of an efficient control system over their observance. The role of the main controllers in the sphere of accounting and reporting traditionally belonged to tax authorities. Following the enforcement of Chapter 25 of the Russian Federation Tax Code as of 1 January 2002, stipulating the legal requirement of separate accounting and tax gross-up, the role of the tax authorities as the main controllers of the accounting process started to decline.

88. At the same time, market mechanisms acting as regulators on developed financial markets (exchanges are the trade organizers on the stock market) play only an insignificant role in this area in Russia. Trade organizers in Russia usually do not require that the issuers present IFRS-based reports for purposes of entering in quotation lists. The only exception is the Russian Trading System that has introduced as early as 1999 the requirement for stock issuers included in the first level quotation lists (A1 quotation lists, according to current classification) to present reports based on IFRS or US GAAP.

89. Some Russian organizations presently apply the International Financial Reporting Standards (IFRS) or the US Generally Accepted Accounting Principles (US GAAP) to drawing up their consolidated accounts. According to the data of auditing and consulting firms, news agencies and investment companies, some 120 banks and 40 major companies whose stocks are traded on the organized market used IFRS-based reporting in 2002, and another 20 companies employed the American US GAAP standards in their financial reporting.

90. Many companies reporting on the basis of IFRS quote their shares on the international capital markets, but some of them (for example, OJSC Krasny Oktyabr, OJSC Gazprom) do not market their securities abroad. According to expert data, some companies are beginning to employ IFRS without planning to induce foreign investors, but mostly for purposes of improvement of their corporate governance and their business image. Such companies include, in particular, large metallurgical enterprises (OJSC Severstal, OJSC NLMK). Public sources (Internet, appearances of the Bank of Russia officials, media publications) have it that about 120 Russian banks apply IFRS in their reporting.

91. Organizations choose this form of reporting on their own initiative, without any statutory requirements, to supplement their reporting as legal entities in accordance with the Russian procedures. In addition, in keeping with RF Finance Ministry order No.112, IFRS can also be used for drawing up consolidated accounts instead of the finance Ministry rules. At the same time, the said rules are set by a document enjoying the status of methodological recommendations, while no other regulations back the relevant provisions. Moreover, there is no officially approved edition of the standards enjoying the necessary legal status.

92. In most cases the companies publish individual reports (reports of legal entities) based on the Russian rules of accounting and consolidated accounts based on IFRS or US GAAP. IFRS-based consolidated accounts are usually published together with an audit report. The terms of preparation and publication of accounts also vary significantly. Companies drawing up reports on the basis of IFRS and US GAAP for purposes of their presentation to international exchanges and subsidiaries of foreign corporations and holdings (Pepsi, Mitsubishi Corporation, etc.) more or less stick to the strict deadlines.

93. In connection with the lack of legally fixed requirements to IFRS-based reporting and control over accounting and reporting, IFRS-based financial reporting drawn up by Russian organizations has, in fact, no legal status and therefore its reliability cannot be fully controlled by the regulator. In the given case, the main controller is the auditor whose opinion, however, under the law o auditing, has no legal force with respect to any kind of reporting complied otherwise than on the basis of Russian law. Therefore the process of drawing up and presenting financial reporting based on IFRS by Russian organizations is, on the whole, uncontrollable by the state, and in the event of violation of investors' and other stakeholders' rights as a result of presenting unreliable information in this kind of reporting, this fact would not entail direct legal implications for the organization at fault.

94. Consequently, in the absence of legal requirements of IFRS-bases reporting, the disclosure and accessibility of IFRS-based financial reporting is rather low. According to expert evaluations, in 2000 only 11 percent of companies employing IFRS reporting disclosed it in public editions, including their websites, and some 25 percent in 2002. The remaining companies did not publish it at all or published it strongly abridged, without the necessary explanations, which restricted users' opportunities to analyze these reports. Moreover, most companies publish IFRS-based reports only in English. Under these circumstances, despite a considerable progress in drawing up IFRS-based reports by the

Russian companies, it is yet early to speak of increased quality of reporting disclosed by the issuers. The current situation would better be described as the recognition of IFRS by Russian companies as a necessary condition for participation in a market economy.

95. The updating of the Russian system of financial reporting has been high on the agenda of the RF Government for over 7 years now.

96. Today the positions of agencies interested in developing the system of accounting and reporting differ strongly, especially on the issue of IFRS enforcement in Russia.

97. The Russian Ministry for Economic Development, the Russian FCSM, and the Bank of Russia hold the opinion that IFRS should be necessary in Russia for certain categories of organizations. The Russian Goskomstat supports the position of the Ministry for Economic Development and comes out in favor of developing government statistics.

98. Representatives of the Russian Finance Ministry express the opinion that it is inexpedient to directly employ IFRS in Russia, as this would require a considerable change in the current reporting and accounting regulatory system. This opinion is reflected in the draft Concept of Accounting and Reporting Development, prepared by the Russian Finance Ministry.

99. The position of the Russian Ministry for Taxes and Levies is reflected in its policy of forming a separate branch of tax gross-up.

100. Work is presently underway to elaborate the Concept of Accounting and Reporting Development in the Russian Federation for a mid-term perspective (hereinafter – the Concept) on the initiative of the Russian Government.

101. The Russian Ministry for Economic Development has prepared a draft Concept, which was coordinated with the FCSM, Goskomstat, the professional and business community (representatives of RSPP, the Council for Financial Reporting took an active part in preparing the draft).

102. The draft defines the goals and objectives of developing the accounting and reporting system, possible scenarios and stages of IFRS enforcement in Russia, proposals for the separation of functions of public and nonpublic regulation of the system of accounting and reporting, and combining tax gross-up, accounting, and statistic reporting at the Russian companies.

103. The principal idea of the draft Concept is the need to reduce state regulation of the accounting sphere along with enhancing the role of the professional and business community, mainly the users of financial reports, by setting up an independent public authority and empowering it with a number of functions, including the coordination of IFRS enforcement at the Russian companies. The quality of this public reporting should be confirmed in the process of independent audit.

4. ROLE OF THE BOARD OF DIRECTORS (SUPERVISORY BOARD) WITHIN THE CORPORATE GOVERNANCE SYSTEM

Russia's property structure is changing, and so is the role of the board of directors as a body ensuring a balance between various groups of shareholders, and between shareholders and the management

104. According to the Russian law on joint stock companies, the board of directors carries out overall guidance of the company's activity, with the exception of issues referred to the competence of the general shareholders meeting. This body works out the company development strategy and adopts the annual financial and business plan. It also exercises effective control over financial and business operations of the company. The board of directors also participates in the resolution of corporate conflicts, control over the activity of executive bodies, ensuring the observance of the company's internal procedures within the frames of which shareholders rights are discharges, etc. Therefore, Russian law empowers the board of directors with responsibilities that make it one of the key aspects of corporate governance.

105. The reforms of the law on joint stock companies and corporate governance conducted during the past several years focused on the role and functions of the board of directors in the company. The 2001 amendments to the law on joint stock companies introducing the responsibility of members of the board of directors and specifying their functions were of great importance.

106. Recommendations concerning the functions of the board of directors are also presented in the code of Corporate Conduct. It is a known fact that the board of directors has an open list of legally established functions (unlike the general shareholders meeting). Therefore the company is granted considerable freedom in specifying a number of special responsibilities of the board of directors in its charter.

107. However, according to numerous surveys, the recommendations of the Code concerning the responsibilities and working procedures of the board of directors have so far not been broadly enforced. Moreover, many surveys have shown that at the end of 2002 many companies have recognized that the activity of the board of directors is **formal by nature**.

108. The spring 2001 research conducted by the Institute of the Stock Market and Management has shown that members of the board of directors of the largest companies spent very little time on exercising their duties – from one to five days a month, newly elected board members were not brought up to date, most companies had no such practice. Only 15% of companies had functional division of responsibilities. The board of directors seldom determines the compensation of the senior management and its own remuneration.

109. The reason behind this state of affairs is the **concentrated property structure** of the Russian companies and the prevalence of the company managers among its shareholders. As a rule, a larger number of shares gives the proprietor more rights to influence the corporation's activity by promoting their representatives to the board of directors – a body developing the corporation's development strategy and controlling its management. The survey of industrial joint stock companies conducted by GU HSE in 1999-2001[7] revealed that the board of directors consists of an average 7.9 persons. The administration and the work collectives are represented most extensively in the board of directors – 38.1% and 20.7%, accordingly. The presence of a controlling shareholder means that it is not interested in achieving a balance between various groups of shareholders, and its coincidence with the company management makes the problem of relationships of the principal and the agent less acute. This signifies actual subordination of the board of directors to the company management and, as a consequence, its formal role within the system of corporate governance. Existing regulations also add to this situation, as they allow managers' unrestricted participation in the board of directors, only unless they are members of the collegial executive body.

110. The analysis of the structure of the Russian companies' board of directors conducted by IFC and the Independent Directors Association (IDA) in 2002-2003[8] also shows that the board of directors most often includes representatives of major shareholders (34% of board members), senior managers and employees of the company (30%). At the same time approximately 25% of members of the board of directors are also executive directors. The number of board members has dropped from 7.9 persons (according to the 1999-2001 GU HSE data) to 6.8 persons (according to the 2002-2003 IFC and IDA data).

[7] The survey of over 400 industrial joint stock companies representing 12 Russian regions (on GU HSE project "Structural Changes in Russian Industry")

[8] The survey of the corporate governance practice in Russian regions prepared by IRG on request from IFX and IDA in 2003.

111. As already mentioned, an optimal distribution of functions between the general shareholders meeting, the board of directors and the Executive Board, on the one hand, contributes to efficiency of the adopted decisions, and on the other hand, creates the necessary conditions for exercising control over managers' performance. In the opinion of participants in the survey conducted by the Investor Protection Association[9], the competence of the general shareholders meeting should include the determining of the amount of compensation of members of the board of directors (about 40% of responses). It should be mentioned that 50% of respondents have failed to answer this question. Such issues as approval of annual budgets, deals with assets, determining the amount of compensation of the senior management, and approval of business plans received no support.

112. The results of this survey **do not demonstrate** an obvious tendency towards enhancing shareholders control over the policy and transactions of the joint stock company via the board of directors.

113. However, there are **some positive indications** of a growing role of the board of directors within the corporate governance system. This is largely due to the appearance and promotion of independent directors, despite the fact that only 28% of the polled companies have independent directors on their boards (IFC/IDA data).

114. All respondents covered by the API survey believe that the presence of an independent director contributes to greater investor and creditor trust. The majority of respondents also think that it ensures the objectivity of public information on the company's activity. Some two thirds of the polled also agree that an independent director puts forward positive idea for consideration of the board of directors and acts as an effective mediator in the resolution of corporate conflicts, and also is an important element in the system of internal control. Over half of the respondents also believe that the presence of an independent director on the board reduces risks involved in the company's major deals. Therefore, the attitude toward independent directors cannot be regarded as purely utilitarian, regardless of the true motive for the answer.

115. It should be mentioned, however, that more than 61% of those who answered the question assume that an independent director may with a high degree of probability turn out to be a covert stakeholder, even be associated with the competition. This tendency is characteristic of banks. Apparently, apprehensions to this effect are not groundless, as directors can operate as information channels or a competitor's agent.

116. This speaks in favor of the presence of **professional directors** who value their reputation and receive decent remuneration, the size of which, however, should depend on the overall performance of the company.

117. Another indication of a certain **increase of the board of directors' role** is the number of annual meetings of the board. The minimal number of meetings of the board of directors evidencing that the board considers strategic matters and at the same time exercises supervisory functions (for example, approving transactions) on developed foreign markets is some 7-8 meetings a year. If the annual number of meetings is four or less, it usually speaks of a purely formal role of the board[10].

118. According to the 2002 API poll of over 400 large and medium Russian companies, several companies held from 5 to 7 board meetings in 2002, while the others held 9-14 meetings. Energy companies held from 11 to 25 board meetings a year, which is connected with their professional specifics, as the sector is in the process of reform. This is normal international practice.

119. On the whole, despite the existence of a restraining factor in the form of high property concentration, **there has been a certain increase in the role of the board of directors in companies** in 2002-2003, specifically the institution of independent directors has become more commonly employed.

[9] Report on the activity of the Investor Protection Association on grant M02-0440 of the Eurasia Foundation. Project "Promoting the Improvement of the Corporate Governance Practice in Russian Companies"

[10] Para 4.2.1. of the Code of Corporate Conduct recommends holding meetings of the board of directors whenever necessary, usually not less than once every six weeks, and in keeping with the meetings schedule approved by the board of directors.

5. JOINT STOCK COMPANIES REORGANIZATION, MERGERS AND TAKEOVERS

The bulk of major assets is so far being redistributed in Russia's economy outside the stock market. But there are still no strict legal rules regulating "non-stock: mechanisms

120. A number of surveys (GU HSE, REB, CEA) demonstrate that starting from mid-1990's, the major proprietor of 6-8% of industrial enterprises on average could have changed annually, i.e. **constant property redistribution** is underway. As a rule, this redistribution is accompanied by a change or strengthening of corporate control. The PWC survey of mergers and takeovers in the Central and Eastern Europe revealed that in 2001 Russia has become the region's recognized leader in the volume (US$ 6 billion) and number (237) of publicly declared non-privatization transactions. The market leaders are major Russian business groups. According to some data, the annual volume of the market of mergers and takeovers exceeds US$ 10 billion.

121. The specific feature of the Russian market of major deals with the company assets is that its most popular form is the contribution of assets, including blocks of shares of one company, to the charter capital of another company. Reorganization is used quite rarely. This is connected with the fact that reorganization requires much administrative activities and involves high legal risks.

122. Russian law envisages five forms of **reorganization procedures:** merger, splitting up, affiliation, secession, and reformation. All these procedures stipulate a special legal regime of interaction of a legal entity with its participants, creditors, and government authorities. Hence it can be maintained that reorganization is not merely a legal institution, but also a special corporate governance institution that needs special consideration.

123. The emergence of the reorganization institution is connected with economic reasons: at the and of the 19th century Europe was living through vigorous industrial integration and redistribution of the accumulated capital in favor of more efficient proprietors. The poor state of development of the stock market called for the elaboration of special reorganization regulations. In their absence these procedures would involve traditional liquidation of the participating companies, which would hamper their normal business.

124. The Russian law on reorganization is similar to the German law on reorganization. But the Russian law attempts to protect the parties to corporate governance from abuse during reorganization by granting them **additional rights,** which is not done by the laws of most European countries. In particular, this concerns **creditors' rights** to demand early cancellation of liabilities in the event of reorganization, which would undermine the companies' financial stability.

125. Regulations guaranteeing the organization participants' rights to **information** on reorganization are insufficient either. For example, the law does not set any requirements to the information to be presented to participants in commercial organizations to enable them to adopt a reorganization decision, or to the order of presenting it. In addition, considering that a considerable share of participants in the reorganized legal entities are not expert on questions that need to be answered during the adoption of a decision on reorganization, the lack of requirements of explanation of the reorganization terms is another shortcoming of the law. The problem of inadequate assessment is rather serious. The law does not set any requirements ensuring that the participants have an opportunity to receive adequate and independent evaluation of the cost of assets and the amounts of debt of the reorganized legal entities. As a consequence, the participants of reorganized commercial organizations are unaware of the actual implications of the reorganization, and cannot evaluate the adequacy of the proposed rate of conversion of stocks (shares) and their market value.

126. It should be mentioned that the Third EU Directive, unlike the Russian law, envisages detailed regulation of participants' rights during reorganization: they are entitled to familiarize themselves with the basic documents (project, financial statements, reports, etc.) at the company office a month prior to the general shareholders meeting. There are strict rules with respect to financial reports presented to the participants.

127. In 2003, the Russian Federation Ministry for Economic Development and Trade conducted a survey of the leading Russian and foreign companies for the purpose of determining demand for legal regulation of the institute of reorganization and individual components. Sixty major industrial, credit and consulting companies responded to the questions. The survey participants were asked to evaluate the degree of acuteness of the problems listed in the questionnaire in the sphere of law on reorganization within the frames of their activity. They were also asked to rate the provisions of the draft Federal Law "On Reorganization and Liquidation of Commercial Organizations"[11] according to a five-point scale (see Annex **table 3**). As we can see from the table, the survey participants rated high the need to develop and new legal framework in the sphere of reorganization. An average number of points was calculated for enterprises in each group (the aggregate number of points was divided by the number of enterprises in the group) and used as benchmarks for evaluating some or other legislative novelties.

128. Russian law leaves practically unregulated the procedures of **purchase of major blocks of shares (takeover)**.

129. The annual volume of the world market of mergers and takeovers numbers trillions of dollars and despite its considerable decrease over the 2001-2002 crisis and the overall weakness of the world business situation, the interest in such transactions is expected to increase in the near future. Relevant stability of the Russian economy enabling the companies to exercise long-term investment and foreign companies' increased interest in the Russian market in connection with the tightening of competition on the national markets give grounds to anticipate a growing demand for legal mechanisms of takeovers in Russia in the near future.

130. However, only Art.80 of the Federal Law "On Joint Stock Companies" is devoted to matters of corporate takeovers. This article stipulates obligatory written notification of a joint stock company with more than one thousand shareholders of common shares of the intention to purchase 30 and more percent of its common shares. After the purchase of shares, the buyer shall make proposals to the shareholders to purchase common shares from them. At the same time, the law establishes several rules connected with the order of discharging such obligations.

131. It is our opinion that the rules presented in Art.80 of the Federal Law "On Joint Stock Companies" are necessary but far from sufficient for ensuring full regulation of issues relating to corporate takeovers. The law lacks provisions on the order and contents of the takeover notification, the order of calling back proposals on the purchase of a large block of shares, or making a competing takeover offer. It is necessary to consider the expediency of attracting a special financial adviser who would sign proposals on the purchase of shares and bear relevant responsibility in the event of default on the deal. At the same time, we believe that the issue of extending the number of joint stock companies regulated under Art.80 should be decided from the position that intensifying the information disclosure regime is expedient for joint stock companies with a large number of participants oriented on attracting investment on the stock market.

6. MAIN LEGAL PROTECTION TRENDS (LEGAL REFORM)

Broad shareholders rights in conditions of weak judicial power and poor enforcement legislation are being used lately for purposes strongly different from protecting legal proprietary rights

132. The specifics and main problem of the Russian practice of gaining corporate control consists in the fact that to purchase a block of shares or major assets of a company it is not no necessary to enter a transaction applying to the organized market or directly to the proprietor and to pay a market price of such shares.

[11] The draft law is available at the website: www.economy.gov.ru.

133. Ways of acquiring assets at a price much lower than their market value have always existed in this country with property and property rights being granted by unlawful court decisions. These methods are most commonly known as **"corporate captures"** and **"forced takeovers."** As a result of such practice, the interests of major proprietors, as well as small shareholders, are unprotected.

134. In the opinion of the participants in the survey conducted in May 2003 by the Managers Association within the Business Activity Index project, factors hampering the development of a normal corporate governance practice include, first and foremost, a high level of hostile captures and takeovers. Insufficient level of the stock market development is the second problem, accounting to a lack of efficient mechanisms of information disclosure on the companies. A lack of information openness and transparency of the companies is another negative factor. The absence of a single reporting system was mentioned last. The respondents' answers overtly demonstrate that captures are in fact a new form of struggle for redistribution of assets and spheres of influence (84% of respondents) and do not contribute to efficient resource allocation within the economy. Only 16% of the polled expressed the opinion that takeovers are connected with considerations of more efficient business – as in the rest of the world – and constitute a means of competition struggle in the face of the constantly growing global competition.

135. The existing situation on the market of corporate control has led to drastic increase in the private sector's demand for legal consideration of disputes over the past several years. According to the HSE-GU data[12], during the past three years 60% of companies participated in arbitration cases in the capacity of claimant or respondent, with the highest demand for the arbitration form of regulating disputes being displayed by major business entities – over 90%. The absolute majority of companies claim that the main violators of their rights and legal interests are the governmental authorities. Second come the company counteragents, third – its shareholders (the survey covered 304 open joint stock companies representing 3 regions of Russia).

136. The survey has demonstrated that representatives of the business community view it a top priority to enhance the quality of the legislation, as they find it rather difficult to determine whether there has been a violation or not, because not all possible forms of violations are envisaged by law. The ambiguousness of arbitration regulations prevents the companies from predicting the outcome of the arbitration case. Enforcement of legal decisions, particularly in the sphere of the law on joint stock companies, is second important.

137. The corporate uptake mechanisms have undergone considerable changes over the past three years. Before the adoption of the new edition of the law on bankruptcy there was a broad practice of such methods as intentional bankruptcy, whereas the most commonly spread practice at the present moment is the contesting of the company's actions by minority shareholders or contesting the actions of the authorities during privatization or discharging regulatory functions on the stock market.

138. The practice of employing the law on contesting has become quite popular. The sequence of actions may be as follows.

139. At first, the company debars its competitor from the state property auction. For this purpose, the company achieves a court determination prohibiting the competitor to participate in the auction despite the fact that the privatization law contains an exhaustive list of grounds for non-admitting a bidder to the auction. The erroneous court decision would be cancelled afterwards by the same judge who had passed it, but at that time the auction for the sale of the state-owned parcel of shares would be over. This sort of conflict is possible due to the inconsistency of the law on civil proceedings and the privatization law.

140. Another option is to cancel the registration of the report on the competitor's additional stock issue results. This can be done on complaint filed by a natural person against FCSM actions. Moreover, the claimant does not necessarily have to be the competitor's shareholder or client.

141. In our opinion, in order to avoid such situations, it is necessary to specify the provisions of the Federal Law "On Court Appeal of Actions and Decisions Violating Citizens' Rights and Freedoms" to rule out the applicability of this law to such relations. This law should be applied exclusively to relations of a public nature (between an

[12] Development of Demand for Corporate Governance Regulation in the Private Sector, autonomous nonprofit organization Projects for the Future: Scientific and Educational Technologies, Moscow, 2003.

individual and a governmental authority, body of local self-government, official, state and municipal officer), for which special legal procedures are envisioned (section III of the Russian Federation Code of Civil Proceedings, section III of the Russian Federation Code of Arbitration Proceedings).

142. Corporate conflicts connected with the application of the **law on arbitration proceedings** have also become quite common lately.

143. Today a claim can be enforced by a ban on holding shareholders meetings, carrying out transactions, adoption of certain company decisions. Such enforcement measures as withdrawal of the shareholders' register from one registrar and passing it over to another, as well as suspension of all operations with the register, are commonly spread. It is precisely enforcement measures that underlie most of the "hostile takeovers" schemes.

144. Enforcement measures are often used as a means of "dubbing" a joint stock company's management bodies. The damage inflicted on a joint stock company and individual shareholders by employment of enforcement measures can be considerably higher than the amount of claim they were supposed to enforce.

145. Although the Plenum of the RF Superior Court of Arbitration holds the opinion that before appointing such measures the court shall request a substantiation of the damage inflicted on the claimant[13], criteria of employing enforcement measures are not legally defined.

146. The law empowers the judge to demand that the claimant applying for the introduction of enforcement measures provide **security on the claim** (a bank guarantee, putting money on deposit, etc.). But this is merely a right ant not an obligation. Perhaps, in certain cases security for a claim should be made compulsory. The law provides no explicit answers to this question.

147. The new law on proceedings refers the resolution of disputes between minority shareholders and companies to the competence of arbitration courts. Nevertheless, the possibilities of using common law courts in regulating corporate conflicts remain.

148. All the aforementioned problems require that the government adopt urgent measures for development of the law on civil and arbitration proceedings. These problems can be partially solved by relevant decisions of the Superior Court of Arbitration of the Russian Federation and the Supreme Court of the Russian Federation.

7. ROLE OF THE STATE AS A SHAREHOLDER

The state remains one of the major proprietors in the corporate sector of the economy

149. The share of the state and municipal authorities in industry in general has been decreasing over the past years, but the intensity of this process has not been very high lately. At the same time, the state continues to hold some 8-10% of joint stock capital in the industrial sector. The representation of the state (governmental authorities) can be observed, in different estimates, on the example of 10-25% of all large and medium industrial enterprises[14]. At the same time, the state started recovering its broad participation in the share capital in the defense complex, while its representation is nearing one third of the companies. It should be mentioned that the state (and municipal) authorities

[13] Resolution of the Plenum of the RF Superior Court of Arbitration of 9 December 2002, No.11 «On Some Issues Relating to Enforcement of the Russian Federation Code of Arbitration Proceedings"

[14] Report on the scientific study "Development of Proposals for Increasing Corporate Governance Mechanisms in the Functioning of Joint Stock Companies in Russia based on Analysis of the Evolution of Corporate Entities, Moscow, HSE (GU), 2003.

are obtaining assets also by investing in creation of new JSCs. Unfortunately, there are no quantitative estimates of this process underway mainly on the regional and municipal levels.

150. The distribution of open joint stock companies according to the proportion of shares in property of the Russian Federation is presented on **diagram 3** of the Annex.

151. As intensive privatization of state unitary enterprises is expected in the future, and therefore, the emergence of new joint stock companies, the problem of specifics of corporate governance in the public sector and its influence on employment of the principles of corporate conduct acquires special significance.

152. According to empirical studies, companies with the dominance of managers in their property structure were the most efficient joint stock companies with state participation over the past years. At the same time, according to RES data, the fact of participation of the state is a negative factor in efficiency characteristics. For example, labor productivity at enterprises with state participation is 75% of that of companies in the same sector without the state as a stakeholder.

153. The size of the government stake also has a certain influence: the larger is its size, the lower is the productivity and efficiency. Moreover, the existence of a "golden share" also produces a negative effect, although it is statistically insignificant.

154. At the same time, other surveys reveal positive trends. The aforementioned HSE (GU) survey was based on a sample of 103 large and largest Russian "blue chip" companies (the years of relevant economic stabilization). The results of the survey have revealed that the efficiency of resource utilization by companies whose shares have been transferred into state holding was higher than that of the companies employing other mechanisms of managing governmental shares.

155. The interests of the state in joint stock companies' management bodies are represented by public officials and other persons who have concluded a relevant agreement with an authorized government authority.

156. The institution of government representatives in its present form has a number of considerable **drawbacks**, including low speed of managerial decision-making, frequent adoption of erroneous and unqualified decisions by government representatives, carrying out actions by government representatives in the interests of third parties, insufficiently responsible approach to exercising their functions. The solution to this problem could lie in creation of the institution of **professional managers – government representatives in joint stock companies' management bodies.**

157. The problem of inefficient management of government parcels of shares can also be solved through development of the institution of **trust management**. At the same time, placing state-owned blocks of shares in trust management still involved abuse and corporate conflicts connected with imperfections of the legislation. A trust manager must coordinate major decisions relating to the joint stock company reorganization, introducing amendments to the joint stock company charter, changing the size of share capital, carrying out major transactions, issue of securities, and approval of annual reports of the joint stock company with the authorized governmental authority in writing. These restrictions lower the efficiency of this mechanism of state participation in the joint stock company.

158. In our opinion, it is necessary to adopt some amendments to effective law in the near future, empowering the trust manager with additional authorities, at the same time lowering the risks involved in trust management by insuring the trust manager's responsibility. The obligatory requirement that the trust managed shall hold a license to securities management should be abolished.

Table 1. (data provided by the Russian Goskomstat and Ministry for Economic Development)

	2002 report	2003 estimate	Forecast					
			2004		2005		2006	
			I version	II version	I version	II version	I version	II version
Direct foreign investment (billion USD)	**4**	**6.5**	**7.1**	**7.8**	**7.8**	**8.5**	**7.9**	**8.8**

Table 2. Comparative table of Draft Russian Law on Insider Information and EU Experience

1	More complete regulation of issues of insider trade require the adoption of a special law "On Insider Information"	Issues relating to insider information should be regulated by the Federal Law "On the Securities Market" in order to avoid contradictions between the two laws. For example, Art. 7 of the draft law "On Insider Information" requires that the issuer disclose information about itself, which is not public, if the possession of such information can exert a considerable influence on the value of its securities. However, the RF Civil Code and the law on the securities market already include the notion "information constituting commercial secret." This sort of information is not subject to disclosure and is protected by law. Problems connected with inadequate usage of insider information may be solved through employment of administrative law.
2	The notion of insider information should be defined as any sort of undisclosed data relating to securities and operations with them, the issuer of these securities and its activity, the disclosure of which can exert considerable influence on the market value of the said securities. The basic criterion in this case is the influence on the market value of securities. The definition is quite broad and covered a considerable number of transactions on the securities market, which would enable the regulator to exercise more efficient control over these transactions. It is necessary to employ speculative categories to provide the regulator with more influence mechanisms.	The vagueness of the notion of insider information would entail many requirements to be observed by the market participants (information disclosure by insiders and issuers, obligatory monitoring for trade organizers, etc.). This requires the establishment of strict rules of conduct for the securities market actors. Otherwise there would be a risk that even if the insider or issuer acts in good faith and tries to abide by all legal requirements, it would inevitably become a violator due to the ambiguous nature of rules and a large number of speculative categories in the law. For example, the draft law "On Insider Information" does not explicitly indicate what sort of information the person in question shall submit to the Russian FCSM, as the draft law does not contain a closed list and the issuer is to present all facts relating to its activity, not constituting public information, the disclosure of which can exert considerable influence on the market value of the said issuers' securities. It is clear that the evaluation of such considerable influence is strictly individual and may be different for different entities (in the given case, the state regulator and the issuer).
3	Deals involving the use of insider information have a negative effect on the securities market and investors' conduct, therefore the adoption of an individual law on this problem is of prime importance.	At the end of 2002, the shares of not more than 200 issuers circulated on the Russian securities market. This means that for a time being the coverage of the draft law will be restricted to these companies. It is also unknown what approximate number of transactions involves the use of insider information and what is their effect on development of the Russian stocks market. Considering the poor stock market infrastructure, the list of information on major facts outlined by the law on the securities market seems quite sufficient for exercising the necessary current control over the use of insider information. However, even assuming that the Russian stock market is in for a boost in the nearest years, the approach to regulating deals involving the use of insider information proposed in the draft law is unacceptable. It is necessary to take into account the experience of European law.
4	The regulator's controlling and supervisory functions and the information disclosure system can allow the tracing and preventing of numerous violations on the stock market. It is important that the regulation system be duly fixed by law.	It is impossible to trace all violations on the stock market, therefore the law should proceed from the need to determine the range of transactions particularly dangerous for the market and focus on their control (selective regulation).
5	The Russian law on should be developed with account for the legislation of countries on insider trade, specifically, provisions concerning the definition of insider information and insider (articles 1 and 2 of the Directive), and persons possessing insider information (article 4 of the Directive), formulation of bans on the use of insider information, and disclosure of this information. The draft law "On Insider Information" takes into consideration the European experience of regulation of this sphere in full measure.	The Directive of the European Parliament and Union on matters relating to insider transactions and market manipulating (market abuse), hereinafter the Directive, and the German law "On Trade in Securities" have serious distinctions from the draft law "On Insider Information." These acts are based on the **principles of selectiveness and target orientation** of regulating the disclosure of insider information and deals involving its use. The European law proceeds from the premise that the main objective of the state is to strictly define the violations and deals inflicting the greatest damage on the securities market participants and apply measures against them. The Directive does not require that all issuers must obligatorily disclose information to the regulator. The issuers should publish such information in **publicly available mass media** rather than present it to the regulator, as the draft law suggests. The Directive requires information disclosure on **concrete deals** involving the use of insider information **by concrete categories of persons (article 6 of the Directive)**. The draft law (article 7) stipulates the issuer's obligation to disclose **a bulk of information** on the issuer's financial and business activity to the regulator, but this information is not strictly defined. Unlike the draft law, the Directive stipulates that issuers or persons acting on their behalf or at their expense shall draw up **a list of persons** employed by them (on labor contract or otherwise) who have access to insider information. Issuers or persons acting on their behalf or at their expense shall update this list a regular basis and make it available to the competent authority on its demand. The Directive introduces the order of notification of the regulator of the reasons for

		delays in information disclosure (item 2, article 6). The Directive envisages **the specifics of regulating the use of insider information** in the activity of particular categories of persons (specifically, journalists) and certain transactions. In particular, the Directive, unlike the draft law, stipulates that it shall not be applied to transactions carried out within the frames of the monetary policy, policy of currency exchange rate, or the sovereign debt management policy. Therefore, according to the Directive, operations of the Bank of Russia, for example, actively participating on financial markets, are not insider deals, as they are connected with the national credit and monetary policy. At the same time, information available to the employees of the Bank of Russia during active financial transactions would be considered as insider information. The differences from the German law "On Trade in Securities" are even more substantial. The requirements of the law concerning the grounds for requesting documents and materials from a professional participant in the securities market are less specific and speculative. In particular, the German law stipulates that **in the event of uncovered violations** the federal supervisory authority is empowered to demand the presentation of information on operations involving insider securities or conducted or being prepared for their own or other persons' use. The draft law suggests the following wording: "**if there are grounds to assume that violations envisaged by article 4 hereof have taken place** as well as if deals are uncovered with respect to which there are grounds to assume that they contain indications of price manipulations, the federal executive authority for the stock market shall be empowered to hold inspections." The German law contains a provision according to which any person (informer) whose share of stocks reaches the level, exceeds the level, or lowers beyond the level of 5%, 10%, 25%, 50%, and 75% of the overall number of the company's voting shares undergone the listing procedure, as a result of purchase, sale, or in any other event, shall immediately, but not later than seven days after the enforcement of the relevant change, notify the company and the federal supervisory authority in writing on achieving, exceeding, or lowering the level of the said shares and the percent of votes secured by these shares by indicating their address, and the date of enforcement of this achieving, exceeding, or lowering of the ownership level. The notification period is calculated from the moment when the person found out or was supposed to find out that his share of voting stocks has achieved, exceeded, or lowered below the relevant levels.

Chart 1. (based on Goskomstat data)

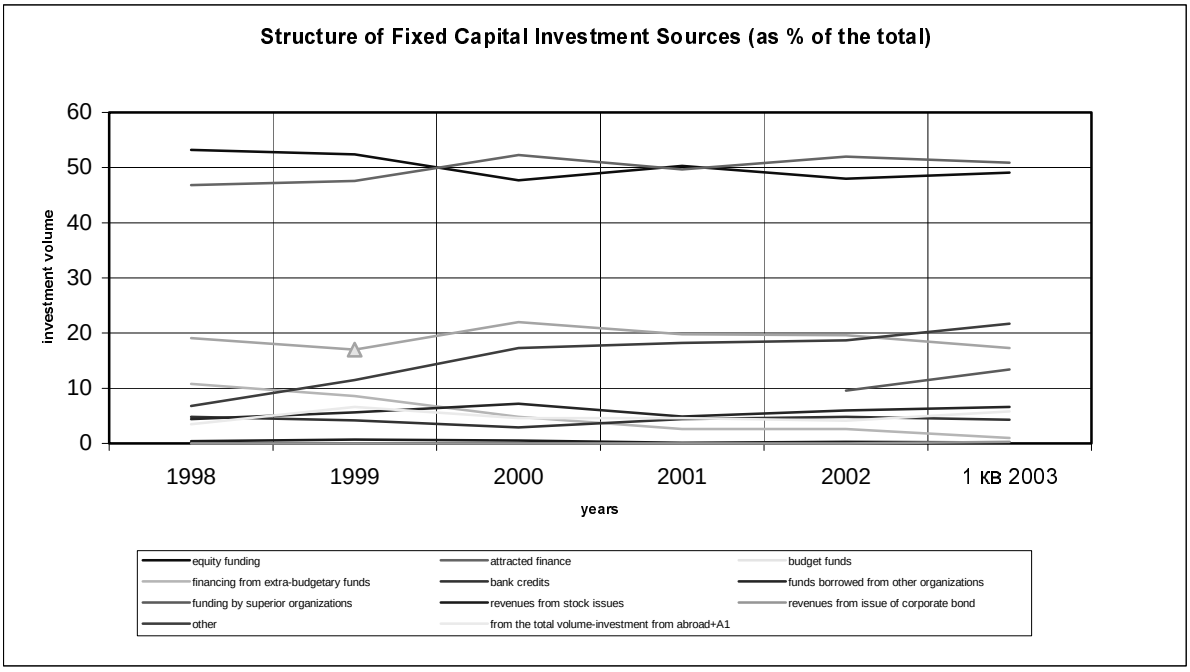

Chart 2. (based on date of the Investor Protection Association)

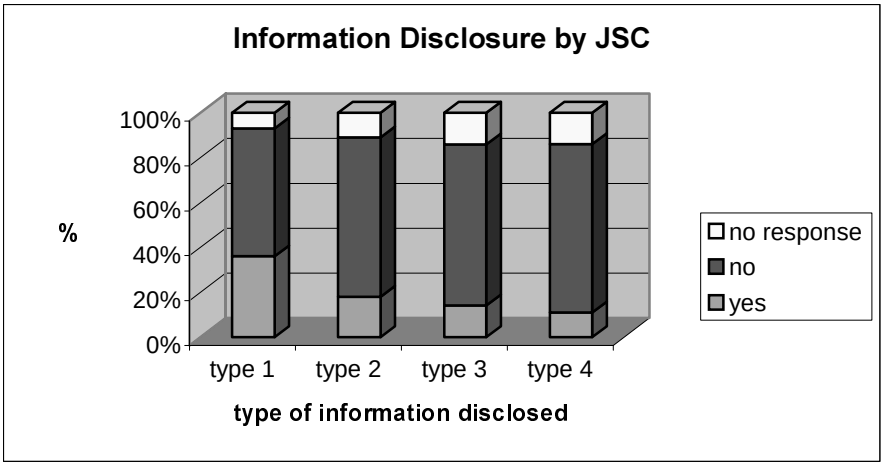

Chart 3. (based on data of the Russian Ministry of Property Management for the end of 2002)

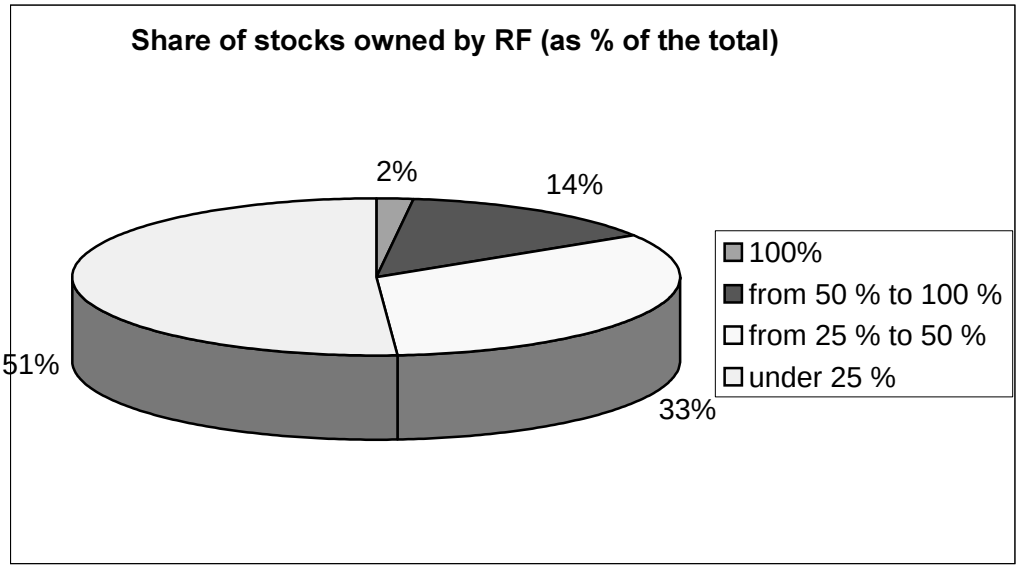

TABLE 3 RESULTS FROM SURVEY, RAITNG OF THE DRAFT FEDRAL LAW "ON REORGANISATION AND LIQUIDATION OF COMMERCIAL ORGANISATIONS"

Problem	I[15]	C[16]	CO[17]	Decision methods	I	C	CO
Lack of distinct legal definition of reorganization and individual forms of reorganization	4.5	4	3.3				
Lack of opportunities for participation in reorganization by legal entities with different forms of incorporation and creating legal entities with other forms of incorporation as a result of the reorganization	4.5	3.1	3	The possibility of simultaneous use of several different reorganization forms within one reorganization procedure with employment of the rules regulating the relevant forms of reorganization, including the introduction of new forms of reorganization: secession and separation through purchase, as well as the opportunity for participation of legal entities with different forms of incorporation in the reorganization creating legal entities with other forms of incorporation as a result of the reorganization.	3.3	4	
The need to carry out several consecutive reorganization procedures in the event of simultaneous use of several forms of reorganization	3.3	3.3	2.8				

[15] Industrial enterprises

[16] Consulting firms

[17] Credit Organizations

Lack of legal provisions regulating the order of convening, preparing, and holding general meetings of participants in organizations created in the process of separation and secession, and the order of adopting decisions by such shareholders meetings on approval of the charter of the created company and the formation of its bodies	4.3	4.1	2	Authorizing the general meetings of participants the reorganized organization to elect the organization's management bodies of organizations created in the process of separation and secession by a single list. The Russian law envisages the holding of general meetings of participants of the newly created companies. The disadvantage of this approach is that the reorganization procedure may be extended for an indefinite period of time until all general (statutory) meetings are held, in case at least one of the newly created companies, for example, has no quorum or the decision is not adopted.	2.3	3	
Creditors' right to demand early cancellation of obligations	3.8	3.4	3.8	Granting the creditors of a reorganized company the right to appeal to court with a claim to terminate or fulfill the relevant obligations of the reorganized company ahead of schedule and compensate for related losses and (or) to assign joint responsibility for the reorganized organization's obligations to its successors. The court shall dismiss such claims if the reorganized organization or its successors prove that the reorganization would not entail the risk of unduly fulfillment of obligations.	3.5	3.5	
Possibility of forced reorganization on decision of an authorized government agency without a court decision	3.5	3.5	3.3	Ruling out the possibility of forced reorganization otherwise than on a court decision. At the same time, restricting the range of persons entitled to file claims. Such reorganization is enforced on a court decision on the claim of an authorized governmental agency.	3.8	3.5	

Insufficient requirements to information to be presented to participants in commercial organizations to enable them to adopt a reorganization decision	4	3.9	3	The need to explain the reorganization terms on behalf and on responsibility of the board of directors. Obligatory participation of an independent evaluator for determining the market value of stocks (shares, stakes) to be used as the basis for calculating the coefficient for stocks (shares, stakes) exchange during the reorganization and the sum of compensation. Extending requirements to information to be presented to participants in commercial organizations to enable them to adopt a reorganization decision, and the order of its presentation. Obligatory notification of the authority carrying out state registration of legal entities of the adopted decision to reorganize.	3.5	3.3	
Lack of special regulations restricting the authorities of the management bodies of a reorganized (liquidated) legal entity in the period between the adoption of the reorganization (liquidation) decision and the end of the reorganization (liquidation) procedure	4.3	4	2.5				

Unreliability of the partition balance and deed of conveyance at the moment of state registration of the created legal entities as the structure of property and obligations could be changed significantly from the moment of approval of these documents by the participants in the reorganized legal entities	4.8	3.9	3.5	Exclusion of the partition balance. Abolishing the need to approve the deed of conveyance during the adoption of the reorganization decision. The rights and obligations should be transferred without a deed of conveyance, and the problems of succession should be stipulated by the agreement on merger, affiliation, or partition by acquisition and secession by acquisition or by the reorganization agreement in the form of division by creation of a new organization and secession by creation a new organization, At present, there is a problem connected with the time interval between the approval of the deed of conveyance and the moment of transfer of rights and obligations (the moment of registration of the newly created organizations) during which the deed of conveyance loses its validity. The deed of conveyance should be formalized. Determining the responsibilities of the external manager (during reorganization) and liquidation commission (during liquidation), as well as the other bodies of a reorganized entity.	3	3.5	
Obligatory alienation of the property of the liquidated commercial organization through public trade in the order envisaged for enforcement of court decisions	4	3.9		Canceling obligatory sale of the property of the liquidated organization through public trade	2.3[18]	4	

[18] We consider it inexpedient to cancel the procedure of obligatory sale of the property of the liquidated organizations through public auction in connection with the fact that as per item 3, Art.63 of the RF Civil Code, if the monetary assets of the liquidated legal entity are insufficient for granting creditors' demands, the liquidation commission shall sell the property of the liquidated entity through public auction. Moreover, it should be mentioned that in some cases satisfying creditors' demands with the property of the liquidated organization may be impossible (presence of indivisible assets and property complexes in the property structure of the organization). The new rule would also infringe the rights of creditors who would be compelled to receive in exchange to their legal requirements only fixed property.

Distribution of property of the liquidated commercial organization among creditors using the order priorities employed in the event of liquidation of inconsistent organizations.	3.8	3	2.8	Fixing an explicit mechanism for the liquidated organization to outline its creditors and coordinate with them the terms of the liabilities. Liquidation shall proceed in such way that all liabilities would be cancelled in due time established by agreements with the creditors, valid at the moment of adoption of the liquidation decision, or new agreements concluded at a later date. The law may envisage that a number of liabilities could be cancelled by depositing relevant sums at a special institution (for example, a court deposit). These rules should replace the procedure of distribution of the property of the liquidated commercial organization among creditors by order of priority, which is justified only in cases of liquidation of inconsistent organizations.	4	3.3	

LIST OF SURVEYS

1. The survey of the practice of corporate governance in Russian regions was prepared by IRG on request of IFC and IDA in 2003.

2. Report on the activity of the Investor Protection Association on grant M02-0440 of the Eurasia Foundation. Project "Promoting the Improvement of the Corporate Governance Practice in Russian Companies."

3. Development of Demand for Corporate Governance Regulation in the Private Sector, autonomous nonprofit organization Projects for the Future: Scientific and Educational Technologies, Moscow, 2003.

4. The survey of over 400 industrial joint stock companies representing 12 Russian regions (on GU HSE project "Structural Changes in Russian Industry").

5. Report on the scientific study "Development of Proposals for Increasing Corporate Governance Mechanisms in the Functioning of Joint Stock Companies in Russia based on Analysis of the Evolution of Corporate Entities, Moscow, HSE (GU), 2003.

6. Surveys conducted within the Business Activity Index project, Managers Association, February – May 2003.

List of Abbreviations

IFC – International Finance Corporation
IDA – Independent Directors Association
HSE (GU) – Higher School of Economics (Government University)
CEFIR – Center for Economic and Financial Research and Development
IET – Institute for the Economies in Transition
MPSF – Moscow Public Science Foundation
IFRS – International Financial Reporting Standards
IC – Interdepartmental Commission for Accounting Reform
NLMK – Novolipetsk Metallurgical Works
RUIE – Russian Union of Industrialists and Entrepreneurs
API – Investor Protection Association
ID – Independent Director
REB – Russian Economic Barometer
CEA – Center for Economic Analyses for the RF Government