High Level Experts Meeting on Corporate Governance Development of State-Owned Enterprises in Russia

SUMMARY NOTE

14-15 December 2006

LOCATION: State University Higher School of Economics
Myasnitskaya str. 20, Moscow

Meeting co-organised by the Russian Ministry for Economic Development and Trade and the OECD

Meeting co-sponsored by:
The Global Corporate Governance Forum and State University Higher School of Economics (HSE)

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I. OVERVIEW OF MAIN FINDINGS

On December 14-15, 2006 senior policy-makers, experts, and representatives of the private sector from Russia and OECD countries met to discuss progress as well as remaining challenges in improving corporate governance and transparency in Russian state owned enterprises. The basis for discussion was a "*Concept Paper on Corporate Governance Development of State-Owned Enterprises (SOEs) in Russia*", which had been commissioned by the Russian Ministry of Economic Development and Trade[1] (MEDT). The paper was a direct follow up to OECD's Russian Corporate Governance Roundtable 2005 meeting when corporate governance of Russian SOE's was for the first time benchmarked against the *OECD Guidelines on Corporate Governance of State Owned Enterprises.* This high level experts meeting was organised in Moscow by the OECD and hosted by the MEDT in cooperation with the Higher School of Economics and the Global Corporate Governance Forum. The key issues raised at the meeting are outlined in this section. The rest of the note presents a more extended summary of the discussions.

Participants focused on four interrelated issues at the meeting. First, the role of state representatives on SOE boards of directors was discussed. Passive boards that do not fulfil their monitoring role and do not ensure the achievement of state objectives remain a common problem. Civil servants also face conflicts of interest that are not clarified in legislation. The recommendations raised at the meeting include: creating clear evaluation criteria for the performance of board representatives, prohibiting civil servants from serving on the boards of fully privately-owned firms, and the use of professionals as state representatives. In terms of negative incentives, the Federal Service for Financial Markets presented evidence of gradually improving legal accountability of state representatives on SOE boards.

Second, the "instruction system", where state representatives are provided detailed instructions on how to vote on agenda items, faced considerable criticism. Participants suggested a number of recommendations, namely (1) using the legal form of joint stock company for all SOEs; (2) separation of regulation from the ownership function in the government apparatus; (3) elimination of preferential treatment for SOEs through market regulations and financial incentives; (4) assurance of greater SOE board independence.

Third, participants debated SOE objectives, and the process of determining them. Generally, experts agreed that the number of SOEs should be reduced through privatisation while the strategic goals of companies remaining in state ownership should be clearly specified. Russian experts introduced several ideas which raised animated discussion, including the introduction of corporate plans, and the withdrawing corporate governance procedures from 100% SOEs.

Fourth, participants reviewed the division of responsibilities between different governmental agencies involved in SOE governance. This system involves overlapping mandates, which make inter-agency coordination challenging. Experts discussed the need for a clearer specification of mandates and their centralisation at the State Property Agency (Rosimushchestvo) and the Ministry of Economic Development and Trade.

In conclusion, participants agreed that this in-depth discussion was helpful in better understanding the challenges to corporate governance in Russian state-owned enterprises and

[1] *The Russian Concept Paper* was first discussed in Paris on 5 October 2006 amongst a small group of Russian policy-makers, OECD Secretariat and members of the OECD Working Group on Privatisation and Corporate Governance of State Owned Assets. A summary note is available upon request.

possible avenues for tackling them. It provided a solid basis for moving ahead on a mutually agreed OECD-Russia initiative "Corporate governance of state-owned enterprises in Russia" (2007-2009). Pending confirmation of funding, the project would be conducted under the auspices of the Russia Corporate Governance Roundtable, using the OECD Guidelines for Corporate Governance of State Owned Enterprises as a benchmark. The project would aim to facilitate and accelerate the planned reform process in Russia by providing input on viable policy options that build on concrete and practical experiences from OECD countries in reforming state ownership.

II. THE STATE AS AN OWNER -- REPRESENTING STATE INTERESTS

The legal responsibility for the corporate governance of SOEs in Russia is divided across multiple agencies. Rosimushchestvo, under the responsibility of the Ministry of Economic Development and Trade (MEDT), nominates representatives to the boards of directors, and is ultimately responsible for the formulation of "instructions on how to vote" to state representatives. However, in the case of strategic companies, these functions are carried out by the RF Government directly rather than by Rosimushchestvo.

Depending on the enterprise, (1) instructions are worked out by Rosimuschestvo and coordinated with MEDT or federal executive body, or (2) instructions are worked out by other federal ministries or agencies and approved by Rosimuschestvo, or (3) instructions are worked out by Rosimuschestvo and can take into account the proposals of other ministries and agencies. Three lists of enterprises determine which of these cases is relevant.

At the enterprise board level, the "state" is represented by civil servants from different agencies (MEDT, industrial ministries, antitrust agency, etc.), mostly by the representatives of industrial ministries. The nomination process for strategic enterprises involves the submission to the RF Government by the MEDT of proposals listing the candidates for the board of directors, and the auditing commission. The nomination for all other enterprises is carried out by Rosimushchestvo.

In some countries, such as Norway, the government is not directly represented on SOE boards: instead, the state only nominates the candidates to be selected by the general shareholder meeting, and sets rules for board composition. According to the MEDT, this model may not be applicable to Russia, however, as it could be perceived as a concealed privatization of SOEs.

The data presented by the Higher School of Economics (HSE) suggests that the state is underrepresented on the board of directors in companies with state equity, relative to the size of state stakes. This could be the result of de facto privatization in which the state representatives give up their decision-making powers in favour of other board members (e.g. private owners or executive management). In yielding its property rights, the state loses the ability to monitor executive management through the board. Alternatively, these results could suggest that the state may not view the board as an important governance institution when the state is a dominant shareholder and decision-making is organised through the system of instructions rather than through the board.

As HSE experts stressed, the issue of under-representation of the state cannot be solved through a simple increase in the number of government representatives on SOE boards. Absent proper incentives for state representatives, their numerical increase would be counterproductive as their votes would be captured by the executive management or private owners. The data on ownership concentration underscores this danger as most companies in which the government maintains

equity have ownership concentrated in the hands of executive organs. The situation indicates that the role of the board should be strengthened if it is expected to carry out supervisory functions.

Legally, the Russian board of directors (*sovet direktorov*) falls between the German supervisory board, and the U.S. management board, but fails to fulfil either function adequately. Currently, legislation is being developed to strengthen the supervisory role of the board (as of yet, no fiduciary duty is established in the law, for example). There seems to be a strong preference for a stable board of directors, which often overlaps with executive management. On the one hand, this preference may be cultural: the absence of intra-corporate conflicts is viewed as positive, but this impedes the checks and balances intrinsic to effective governance.

Currently, there are no incentives (positive or negative) for the civil servants representing the state on the board of directors to actively participate in governance. The law «On public service» prohibits any rewards for civil servants except for his/her duties, and the system of top-down instructions further reduces any governance-oriented initiatives of state representatives. At the same time, the office of state representative on the board of SOEs is often politicized and frought with conflict of interest. The currently ongoing reform of state property management envisions result-oriented motivation, possibly through bonuses to the ministries that send their representatives to the boards of directors. However, as HSE points out, such positive incentives provide only a partial solution that will only be effective if, on the one hand, the role of the boards is increased as such, and, on the other hand, civil servants on the boards are provided with company-specific guidelines (in addition to the strategic goals more generally).

The dominance of personal agendas may also explain why state officials often sit on the boards of fully *private* firms: 17% of companies with board members from federal (or 44% from regional) state authorities have no shares that belong to the state, according to the HSE surveys. The presence of state officials on the boards of private firms may reflect the use of the board as an instrument of industrial policy by the state. It may also be caused by the collusion between private businesses and state officials for mutual gain. Likewise, it may reflect the local state officials' desire to have first-hand access to information relevant for the administration of the region. Whatever its reason, experts suggested that the participation of state actors in the governance of private firms should be restricted or prohibited, in particular because the current legislation does not prevent conflicts of interest arising in such cases.

The majority of state representatives on SOE boards are civil servants – however, there are no legal obstacles to the use of professional managers as state representatives. The main problems in appointing professional managers are the difficulties in the evaluation of the impact such professionals can make on company performance, and the lack of qualified personnel. Clear requirements that vary by company and specify the education and experience levels for professional managers are also needed. Finally, a transparent selection of such professionals is necessary: otherwise, they may become de facto representatives of institutional investors.

Overall, the "instruction system" has shortcomings which offer important opportunities for reform. Such reforms would aim to replace the passive and sometimes opportunistic firm-level state representatives with active and competent board members devoted to sound corporate governance. The most urgent measures could include: (a) the creation of tools to assess the performance of state representatives, and the activity of board of directors in general; (b) the prevention of the conflicts of interest for civil servants engaged in SOE governance; and (c) the design of positive and negative incentives for professional state representatives.

The experience of OECD countries suggests several recommendations. First, participants recommended that SOEs become registered as "corporations". This should be the case even when the state owns 100% of the enterprise. As an example, despite intense debates on the privatization of the telecom firm Swisscom in Switzerland, all sides agreed that the company should be organized as a corporation. Such a legal form facilitates both professional decision-making and access to capital.

Second, various functions of the state with respect to SOEs should be organizationally separated for governance purposes. This applies particularly to the separation of ownership from regulatory functions – these should be performed by separate governmental department agencies. As a matter of principle, SOEs should be subject to the same regulations as any other firm. The state should behave as one, i.e. not interfere with day-to-day management of the firm. The division of ownership from regulatory functions implies that the Russian practice of having the ministers or elected officials in the capacity of board members is not advisable.

Third, SOEs should not receive preferential treatment in the market. In Poland, for example, SOEs function on the same legal basis as private firms. A level playing field is particularly important in the capital market. Banks should treat SOEs as any other firm, which means that SOEs should be allowed to go bankrupt.

Fourth, the board of directors should be sufficiently independent from management to carry out the functions of monitoring and of strategic guidance in the company, subject, of course, to the objectives set by the owners. The board – and not the ownership entity – should have the power to appoint and remove the chief executive officer. The boards of SOEs should carry out an annual evaluation of their own performance, and present it to the nominating committee, which may further present it to the general shareholders assembly to ratify it.

The international experience drawn from Norway and Germany suggests that regardless of whether the state representative is a civil servant or a professional manager, he or she should be subject to legally binding fiduciary duty in order to ensure the representative's politically independent commitment to the effective governance of the company. The board of directors should fulfil the agenda set forth by the shareholders – the state can nominate the board at the general shareholder meeting, but should then let the board carry out its firm-oriented obligations. Finally, in contrast to Russia, the Polish civil servants can only be appointed to the board by the state which makes it impossible for state employees to serve on the boards of private firms.

III. DETERMINING THE OBJECTIVES OF SOEs

The formulation of goals for SOEs presents a challenge due to the tension between the profit objectives for any enterprise, and a wide range of public policy motives typical for SOEs. Participants suggested that transparency and a clear specification of those goals that go beyond profitability is essential to allow the governance system to implement these goals at the enterprise level.

In Russia, the determination of strategic goals for SOEs resides mostly with sectoral ministries, and is not transparent. Although the list of strategic enterprises is public, it appears politicized, and could probably be reduced, according to the MEDT. In general, enterprises whose only objective is profitability should be privatized.

Furthermore, there was considerable debate on a proposal by HSE experts to withdraw corporate governance structures and procedures from 100% state-owned enterprises. They suggested that fully state-owned firms could be reorganized in a legal form other than a joint-stock company, and the management of these enterprises could be directly subordinated to the federal ministries. It was argued that this might clarify the governance, since the present situation of automatically confirming "instructions" renders the role of the board meaningless. A number of participants disagreed, claiming that removing the instructions system would resolve this and that even fully owned state-owned enterprises would full benefit from improving their corporate governance practices, as referenced in the OECD Guidelines on Corporate Governance of State Owned Enterprises.

Participants suggested that for all SOEs clear objectives be set. Once the non-commercial functions of specific SOEs are specified, the question arises of how to compensate the enterprises – including their private shareholders – for the socially valuable or strategic functions carried out by the firm. The process of such compensation is not specified in Russia.

Russian experts suggested that a possible solution could be the creation of a corporate plan that would specify priorities for the SOEs in which the state has a majority stake. A clear specification of strategic goals would prevent arbitrary interference of state organs with enterprise operations. A corporate plan would also help to develop performance-based contracts with CEOs, and to assess the role and performance of the board of directors. The corporate plan would replace the system of instructions. It would also allow monitoring of whether the strategic goals of the state in the company are really important to the public.

A corporate plan could take on several legal forms, each presenting distinct trade-offs with respect to its completeness, specificity, degree of mandatory obligations, as well as the confidentiality of potentially sensitive information. The four reviewed legal forms include (1) company's charter; (2) decree of RF government; (3) contract with the company; and (4) agreement among shareholders.

OECD participants viewed the decree of the RF government as the weakest option. If binding, such a decree could become a straightjacket for the enterprise; if non-binding, it is useless in terms of the governance impact. Still, as MEDT noted, governmental decrees can be useful as a fallback in case no other goals have been specified for a particular enterprise. All participants agreed that a contract with the company (third option) probably offers the most benefits as it is flexible, public, and binding.

As the experience of Norway suggests, the state should act as an active, long-term, predictable owner. For this purpose, the state should regulate in a transparent fashion the board nomination process. Norway provided an example where the state mandates the participation of women, as well as the presence of labour, on the board.

As for the goals of SOEs, Norway's SOEs combine profit objectives with a long-term interest in industrial development and investment. SOEs are subject to bankruptcy proceedings. The objectives of each company are written down in the charter, according to company law. There is also a document outlining the state's ownership policy. This document is renewed each year – it is presented to the parliament, and it is made public, which acts as a message to the markets. The objectives of Norwegian SOEs span environmental, managerial, and anti-discrimination considerations: some of these go beyond short-term profit maximization, but are regarded as important by the Norwegian state.

As was emphasized by the OECD, corporate governance addresses effective achievement of goals, including strategic ones, as long as these are clearly specified in the corporate charter. Hence, sound corporate governance is in the interest of all owners, including the Russian Federation.

IV. THE STATE AS A CONTROLLING OWNER AND A MINORITY SHAREHOLDER

The pattern of state ownership in Russia can be summarized as follows (based on the data from the SU-HSE surveys). The federal state has larger blocks of shares than regional governments. In JSCs with federal interest, the state is the second largest type of shareholder with holdings of 40% on average. In JSCs with regional participation, the regional governments rank third or fourth, along with the federal state, and own about 24% on average. Overall, out of all enterprises with state ownership, 11% are 100% state-owned; in 12% of firms the state holds between 50%+1 share and 100%; in 25% of firms the state holds between 25%+1 share and 50%+1 share; in 42% of firms the state holds less than 25%+1 share.

The data provided by HSE shows that many SOEs have minority state blocks of shares despite the officially declared privatization goals for enterprises where the state holds less than a blocking stake. This is particularly relevant for firms in which the local governments hold equity: more than half of such enterprises do not have a state blockholder. As HSE noted, the state may become more active in privatizing such firms if the government elaborates its strategic goals for corporations with state equity. In this sense, the absence of a clear 'strategic' conception for SOEs and the persistence of ineffective minority state-owned equity shares are interrelated issues.

After firms with minority state stakes and the 100% state-owned enterprises are subtracted from the entire pool of 3,000 SOEs, about 1,000 firms remain. According to HSE, the independence of state representatives is particularly relevant for this subset of SOEs where the size of state equity is intermediate.

Participants discussed some of the differences between the minority and majority state-owned firms. Majority state-owned enterprises are more present among the publicly listed corporations. Those state-owned firms which are not yet listed but have expressed intentions to list are also more likely to have a majority government stake. As a result, majority state-owned firms tend to conduct a more active dividend policy. At the same time, majority-owned state enterprises are more likely to cooperate with stakeholders, such as labour. In general, the coordination of key decisions with various stakeholders is positively correlated with the size of state participation

Another difference concerns the probability of receiving state support. In the case of *operational* support (information, exhibitions, etc.) to firms with state ownership, such a probability grows linearly as the size of the state stake increases. The probability of receiving *financial* support, however, is U-shaped, i.e. the percentage of minority state-owned firms receiving support is disproportionately large. This is usually the case with regional administrations that hold small stakes in enterprises. The situation presents an obstacle to privatization since it is preferable from the company's viewpoint to retain a small state stake in order to receive financial support.

The Russian state retains a golden share in about 259 JSCs. The institution of golden shares was introduced during privatization, and was present in 6% of JSCs at that time, but has been decreasing yearly since then. The SOEs with a golden share display more active state

participation in governance through the boards of directors, and the internal audit committees; hence, the golden share as such is barely used.

A comparison of intra-corporate relations in minority and majority state-owned firms reveals that conflicts – either between controlling and minority shareholders or between shareholders and managers – appear to be more prevalent in enterprises where the state holds a majority stake. One particular suggestion is for the state to self-impose an obligation to disclose its goals in a company if the stake is larger than 50%. Furthermore, minority shareholders should have the right to ask for a buyout of their shares if declared state goals change radically at the general shareholder meeting.

V. INVESTOR EXPERIENCE AND ADMINISTRATIVE CONTROL

S&P data in 2006 demonstrates that the Russian SOEs consistently lag behind foreign SOEs and Russian private peers in terms of transparency; this trend is not improving. The data is drawn from publicly available sources (annual reports, web sites, and regulatory filings), and shows that the gap between the Russian SOEs and the foreign SOEs (scores 53% and 71% respectively, as compared to international best practice) is largest regarding information on ownership structure and shareholder rights. The gap between the Russian SOEs and their Russian private peers (scores 54% and 65% respectively) is largest regarding financial and operational information. In terms of disclosure sources, both gaps (with foreign SOEs and Russian private peers) are especially pronounced in annual reports.

S&P concludes that corporate decisions in SOEs are usually made by the government, not by the company boards (which merely vote based on "instructions"), and that there are indications that the Russian federal or regional authorities may be promoting political or personal agendas through the firms.

In terms of administrative code violations by state officials involved in SOE governance, the data presented by the Federal Service for Financial Markets (FSFM) shows that the majority of violations in 2005 concerned insufficient information disclosure (59% of all violations), followed by violations in the process of emitting new shares (22%), and the non-fulfilment of instructions (7%).

However, there have been a number of positive developments in the legislation on administrative responsibility, initiated by the FSFM. First, legal administrative responsibility has been extended, including board directors, executive managers, etc. Second, sanctions for the violations of the administrative code have been increased (higher fines, disqualification option, etc.). Finally, the range of legally punishable violations has increased; now including violations of proper document storage, and violations in preparing and administering general shareholder meetings.

These initiatives have been coordinated with the Interior Ministry and the Ministry of Justice, which has somewhat slowed down the reform process, and will next be discussed by the Duma.

Despite the benefits this legislation will bring to SOE governance, if adopted, a number of challenges will remain unresolved. First, the amendments to the administrative code are insufficient to address the issue of state officials' abuse of privileges, and have to be complemented by changes in the civil code, and the criminal code. Second, better legislation will be effective only to the extent it is supported by proper enforcement, and competent courts. Third, the FSFM has insufficient investigative powers and the evidence it gathers cannot be admitted in

court. This is partially the result of resistance from the Interior Ministry, which is disinclined to share enforcement privileges, as well as from the MEDT which opposes what it regards as over-regulation.

Finally, as stressed by investors, the OECD, and government officials at this expert's meeting, the emergence of a true corporate governance culture is vital. Such a culture-based approach should involve the understanding of the principles and values behind corporate governance, and replace the 'box-ticking' mechanic approach in which superficial institutions fulfil certain criteria but do not bring real benefits in terms of effective achievement of corporate goals. This would complement the creation of specific incentives intended to guide the behaviour of economic actors.