

SESSION III: MECHANISMS FOR EQUITABLE TREATMENT

Presentation on
Regulation of the Disclosure of Information on Affiliated Persons of Joint-Stock Companies
by

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Regulation of the Disclosure of Information on Affiliated Persons of Joint-Stock Companies¹

1. Russian legislation regulating information disclosure by securities issuers consists of the Federal Law “On the Securities Market,” which sets out basic requirements for information disclosure by issuers, and a number of regulations of the Federal Commission on the Securities Market (FCSM) and the Bank of Russia, which expand on and specify these requirements. They include²:

2. Standards of Share Issues during the Creation of Joint-Stock Companies, Extra Share and Bond Issues, and Their Issue Prospectuses (approved by FCSM regulation N. 47, dated November 11, 1998);

3. Standards of Share and Bond Issues, and Their Issue Prospectuses during the Reorganization of Commercial Organizations (approved by FCSM regulation N. 48, dated November 11, 1998);

4. Statute of the Quarterly Report of the Issuer of Securities (approved by FCSM regulation N. 31, dated August 11, 1998);

5. Statute of the Procedure for Disclosing Information on Important Developments (Events and Actions) concerning Financial and Economic Activities of the Securities Issuer (approved by FCSM regulation N. 32, dated August 12, 1998);

6. Statute of the Procedure for and Scope of Information Disclosure by Joint-Stock Companies during the Placement of Shares and Convertible Securities by Subscription (approved by FCSM regulation N. 9, dated April 20, 1998);

7. Statute of the System of Information Disclosure in the Securities Market (approved by FCSM regulation N. 2, dated January 9, 1997);

8. It is these requirements, including the requirements for the scope of and procedure for information disclosure, and their assessment, that our report at the OECD conference (organized in cooperation with USAID and the World Bank) in May-June 1999 was devoted to. Since that time the FCSM regulations on information disclosure have been augmented to include Regulation N. 7 “On the Procedure for Accounting for Affiliated Persons and Information Disclosure on Affiliated Persons of Joint-Stock Companies,” dated September 30, 1999.

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

² This report does not cover information disclosure rules for credit organizations issuing securities, which were established by the Bank of Russia.

9. In accordance with these regulations the main sources of information are the prospectus for a securities issue, a quarterly report, reports on important developments, and the list of affiliated persons of a joint-stock company³

10. If a general assessment of the regulatory framework in this area is to be made, one has to recognize that currently it is fairly chaotic in nature. This is largely due to the continuing changes in the Russian corporate and securities market legislation. In spite of that, even the existing regulatory system gives investors grounds to expect the disclosure of information on major shareholders, shareholders' agreements on joint actions, other affiliated persons of issuers, major and interested party transactions. Even at this stage there are sanctions that can be imposed on those who violate the information disclosure rules, and they have already been applied.

2. Information Disclosure on Company Officers, Major Shareholders and Other Affiliated Persons of a Joint-Stock Company

11. It should be pointed out from the outset that Russian requirements for information disclosure on company officers, major shareholders, and other affiliated persons are fairly strict (for instance, the requirement that information be disclosed on shareholders who own at least 5 percent of shares and votes and also the requirement that information be disclosed on a wide range of affiliated persons). Some of them might seem excessive. For example, the requirement for information disclosure on benefits paid to company officers has been heavily criticized.

12. Weak enforcement is one of the most serious shortcomings in the system of disclosure regulation. This is attributable to the fact that the regulations containing information disclosure requirements are scattered in different regulations, whose authors adopted different approaches. This is the reason why it is so difficult to reconcile these requirements. For instance, the requirement that information on shareholders who own at least 5 percent of votes be disclosed, which is set out in the Issuance Standards, overlaps with the requirement for information disclosure on affiliated persons, as they are defined in the Federal Law "On Competition and Restriction of Monopoly Activities" with respect to those who own 50 or more percent of the votes. Moreover, this federal law takes account of the possibility – forgotten by the standards – that a trustee or some other persons may influence the management of a company, for which reason the law introduces the term "indirect control of votes," linking it to the ownership of 50 or more percent of the votes. Application of the requirements for information disclosure to persons who may have influence on major shareholders of a joint-stock company encounters similar difficulties. Issuance standards stipulate that the names of shareholders who own 25 percent of the authorized capital (equity) be disclosed. This requirement, however, applies only to shareholders who own at least 5 percent of shares. The shareholders who own at least 5 percent of the votes, however, fall under the "indirect control of votes" provision of the Federal Law "On Competition and Restriction of Monopoly Activities," which, as was mentioned above, is linked to a share of at least 50 percent of the votes.

13. These examples highlight another problem – the absence of a uniform approach on the part of regulators. It is not clear what share of the votes was regarded as substantial by lawmakers from the viewpoint of having an impact on the management of a joint-stock company. While the lack of a uniform approach in different regulations is but understandable, there is no reason why it should be absent in just one regulation. Another graphic example of this inconsistency is the requirements of the Federal Law "On the Securities Market." Under the law, a prospectus for a securities issue must disclose information on shareholders who own at least 5 percent of the authorized capital (Article 22), whereas in the quarterly report and reports on important developments (Articles 30 and 23 respectively) information is to be disclosed only on shareholders who own at least 20 percent of the authorized capital.

³ This report interprets any regulation insofar as it applies to joint-stock companies, although these regulations apply not only to joint-stock companies, but also to other legal entities that issue securities.

14. Certain types of information subject to disclosure under the current legislation might mislead an investor who has no specialized knowledge. A case in point is any information on the shares of shareholders in the authorized capital. An investor who overlooks the possibility that shares may have different book values, that there may be no relation between the shares' book value and the number of votes, or that the book value of one's share in the authorized capital of a limited company may differ from one's number of votes may jump to wrong conclusions if he uses this information to assess the degree to which some people or other influence the management of a joint-stock company. The same may be true when an investor gets information on a shareholder's stake, but is unaware of the possible existence of non-voting or multi-vote shares.

15. Finally, there is yet another obstacle to information disclosure worth mentioning, namely, the fact that information disclosure on certain affiliated persons is based on their own conscientiousness. Clearly, a joint-stock company cannot but have information on its officers, but it may well be uninformed about changes in the relative stakes of its major shareholders. For this very reason the Federal Law "On Joint-Stock Companies" requires affiliated persons themselves to notify a joint-stock company of the purchase of its shares (Article 93). It is also understandable that if they make no such notification the joint-stock company will be unable to disclose any information on such affiliated persons until it learns about them during the compilation of a list of shareholders for a general meeting vote or the allocation of dividends. The situation is even worse for other types of affiliation (for instance, in the event of "indirect control of votes"). A joint-stock company may never learn about such affiliated persons, whereas the law does not require them to notify it. It all makes information on affiliated persons subject to disclosure by joint-stock companies fairly inaccurate.

16. Although Russian legislation on information disclosure offers numerous reasons for criticism, one cannot but admit that even at this stage it makes it possible to reveal a plethora of the most important relations that may have an impact on the management of a joint-stock company.

17. So, who are the persons on whom an investor can obtain information?

Company Officers

18. Current regulations require that information be disclosed on the following officers of a joint-stock company:

- Persons who perform the functions of a one-man executive body;
- Members of the collegial executive body of a joint-stock company;
- Members of the board of directors of a joint-stock company.

19. This information shall be disclosed in issue prospectuses and in quarterly reports.

20. Information on these persons subject to disclosure includes the number of shares they own in a joint-stock company and also the size of their stakes (percentage of shares) in the authorized capital of affiliated companies and subsidiaries of the joint-stock company.

21. In addition, the joint-stock company is obliged to disclose information on the purchase of shares in it by the aforementioned persons, stakes (percentage of shares) in the authorized capital of affiliated companies and subsidiaries of the joint-stock company, and also any changes in such stakes (percentage of shares).

Major Shareholders

22. The rule for information disclosure on major shareholders contains two criteria – the percentage of shares and the percentage of votes – that help define such shareholders.

1) Under the Federal Law “On the Securities Market” and FCSM issuance standards, any joint-stock company is required to disclose in its issue prospectuses information on shareholders who own at least 5 percent of shares.

23. The FCSM requirement that information on the percentage of shares be disclosed in quarterly reports depends on two circumstances: (1) whether or not the issuer placed securities by open subscription and (2) whether the securities issuer is included by registration authorities in the list of issuers whose securities issues are subject to registration with the FCSM⁴. Joint-stock companies that undertake an open subscription to their securities and those whose securities issues are to be registered with the FCSM are expected to meet stricter requirements compared to others: they have to disclose information on shareholders who own at least 5 percent of shares and also on their members who own 25 percent of their authorized capital (25 percent of shares) in their quarterly reports, whereas the other joint-stock companies disclose data only on those who own at least 20 percent of shares.

24. In the event that somebody purchases more than 5 percent of shares in a joint-stock company that placed its shares by open subscription or in a joint-stock company whose securities issues are subject to registration with the FCSM, or if he purchases more than 20 percent of shares in any other joint-stock company, and also in the event this percentage of shares changes by a multiple of 5 percent, these joint-stock companies are required to disclose that in the form of reports on important developments.

25. These requirements are based on the Federal Law “On the Securities Market.” However, in order to assess the stakes of affiliated persons one should bear in mind that the Russian legislation provides for non-voting and multi-vote shares. For this reason, information on the percentage of the overall number of shares owned by a shareholder does not reflect the shareholder’s influence on the management of a joint-stock company. Nor does it reflect his actual share in the joint-stock company’s equity, since the Standards exclude from such calculations certain categories of preferred stock.

2) Joint-stock companies are required to disclose in their issue prospectuses and quarterly reports information on shareholders who own at least 5 percent of votes to be case at a general meeting of shareholders.

26. This information reflects more accurately the balance of power in a joint-stock company and the ability of specific shareholders to influence the management of their company. For this reason it is more useful to an investor than information on a percentage of the overall number of shares owned by a shareholder. Given that, the requirement that information be disclosed on shareholders who own at least 5 percent of the votes, which was present in the Russian legislation as far back as 1992⁵, was retained in the FCSM regulations.

27. The list of shareholders subject to information disclosure under this requirement includes all the shareholders who have at least 5 percent of votes at a general meeting of shareholders, including shareholders who own preferred - usually non-voting – shares, which were transformed into voting stock due to non-payment or incomplete payment of dividends.

⁴ This list comprises issuers whose securities issues are to be registered by the central staff of the FCSM. These issuers are part of a special list that is compiled proceeding from the importance of the securities for the Russian stock market (currently it includes 498 issuers).

⁵ The requirement that information concerning shareholders who own at least 5 percent of the votes be disclosed in issue prospectuses was set out in Instruction N. 2 of the Ministry of Finance of the RF, dated March 3, 1992. Subsequently, starting from 1994, the Ministry of Finance required issuers to disclose this information also in their annual reports, which functioned as an instrument of periodical information disclosure on the issuer.

28. Information on changes in the list of shareholders who control at least 5 percent of the votes and their respective shares in the overall number of votes is subject to prompt disclosure in the form of reports on important developments. Joint-stock companies that place their securities by open subscription or those whose share issues are to be registered with the FCSM in accordance with the List of Registration Bodies are required to disclose information on the acquisition of at least 5 percent of the votes in the issuer's highest executive body, and also disclose changes in this share by a multiple of 5 percent.

Cross-Share Holding

29. Regulations require both the issue prospectus and quarterly reports of a joint-stock company to specify:

- a) legal entities that hold a stake in it (regardless of the percentage of shares they own) in whose authorized capital the issuer has a stake (percentage of shares) of at least 5 percent; and
- b) officers of these legal entities who own shares of the issuer (regardless of the percentage of shares they own).

30. One drawback of this requirement is that it is based on shares in the authorized capital (the overall number of shares), which conveys little information that could help assess a joint-stock company's influence on the management of such legal entities and their influence on the way the joint-stock company is run.

31. There is no prompt information disclosure rule on changes in cross-share holding.

Other Affiliated Persons Not Mentioned Above

32. The term "affiliated persons" deserves special attention. Requirements for information disclosure on affiliated persons reflect certain concepts in that regard that have yet to take definitive shape in the Russian legislation.

33. The term "affiliated persons" together with its definition first appeared in Russian law in 1992 in the Statute of Investment Funds and the Statute of Specialized Privatization Investment Funds To Accumulate Privatization Checks of the Citizens, approved by Presidential Edict N. 1186, dated October 7, 1992. In these regulations the term "affiliated persons" was used for the purpose of regulating the operation of investment funds.

34. Subsequently the term "affiliated persons" was used in the Federal Law "On Joint-Stock Companies," which came into force in 1996. The law did not define the term, but it made a reference to the anti-monopoly law (Article 93). The anti-monopoly legislation produced that definition only two and a half years later, after corresponding changes were made to the Federal Law "On Competition and Restriction of Anti-Monopoly Activity." But even before that definition emerged, the FCSM demanded that information on affiliated persons be disclosed in issue prospectuses starting from September 1996, when the first version of the Standards of Share Issues during the Creation of Joint-Stock Companies, Extra Share and Bond Issues and Their Prospectuses came into force. Thus the requirement for the disclosure of information on affiliated persons had remained vague for more than a year and a half, a vagueness that was compensated for in practical work by FCSM explanations based on the definition in the Statute of Investment Funds.

35. It should be said that the process of defining the range of affiliated persons is yet incomplete. In January of this year the State Duma passed in first reading the Federal Law "On Affiliated Persons" that

contains a new definition of this term, which expands the list of affiliated persons compared to the current version.

36. Currently the term “affiliated persons” is defined in the Federal Law “On Competition and Restriction of Anti-Monopoly Activity” (Article 4). In accordance with this definition **affiliated persons are physical and legal persons capable of exerting influence on the activity of legal and/or physical persons engaged in entrepreneurial activity**. The law does limit itself to this provision, however, and defines affiliated persons by direct enumeration.

37. Among affiliated persons not mentioned above, but covered by the information disclosure requirements, the following persons are listed:

- 1) persons belonging to a group of persons of which this joint-stock company is part, in particular⁶:
 - a person or a number of persons who by agreement (through agreed actions) have the right to directly or indirectly control more than 50 percent of the overall number of votes corresponding to a joint-stock company’s equity. Such persons include not only shareholders, trustees, managers by agreement on joint actions, representatives etc., who have the right to control more than 50 percent of votes in a joint-stock company, but also persons who have similar authority with respect to such a shareholder, trustee, etc.;
 - a person or a number of persons who, by contract or otherwise, have acquired the ability to determine decisions made by a joint-stock company, including the way its business is run;
 - a person who has the right to appoint the legal person’s one-man executive body and/or more than 50 percent of the members of its collegial executive body and/or if more than 50 percent of the members of the legal person’s board of directors or another collegial executive body have been elected at his recommendation;
 - legal persons that are part of the same financial-industrial group together with the joint-stock company;
 - members of the boards of directors (supervisory boards) or other collegial executive bodies, collegial executive bodies of members of a financial-industrial group of which the joint-stock company is part, and also persons that perform the functions of one-man executive bodies of members of a financial-industrial group of which the joint-stock company is part.

3. Publication of Information on Affiliated Persons and Disclosure at Investors’ Request

38. Last autumn the FCSM adopted the regulation “On the Procedure for Accounting for Affiliated Persons and Disclosure of Information on Affiliated Persons of Joint-Stock Companies.” The Federal Law “On Joint-Stock Companies” required companies to keep registers of their affiliated persons and to disclose lists of affiliated persons at their shareholders’ requests – and open joint-stock companies were even required to publish such lists. These requirements were unenforceable, however, until this term was defined in the Federal Law “On Competition and Restriction of Anti-Monopoly Activity.” Upon its coming into force the FCSM was simultaneously tasked with devising the procedure for accounting for affiliated persons.

39. In accordance with the current procedure, a joint-stock company is required to give its shareholders access to the list of its affiliated persons and, moreover, provide them with a copy of this list within 10 days at a price not above production cost.

⁶ The definition of the term “group of persons,” set out in the Federal Law “On Competition and Restriction of Anti-Monopoly Activity,” is too unwieldy as it includes not only the persons who may have influence on a joint-stock company, but also those on whom the joint-stock company may have influence. This report cites examples of only such persons who may influence a joint-stock company themselves, not the other way around. Apart from that, certain items of the list are not quite clear in the context of the Russian corporate legislation. Who is meant, for instance, by a person “who has the right to appoint the legal entity’s one-man executive body and/or more than 50 percent of its collegial executive body?”

40. Open joint-stock companies are required to publish lists of their affiliated persons on an annual basis.

41. One drawback is that the publication of such lists of affiliated persons, as provided for in the Federal Law “On Joint-Stock Companies,” duplicates the same information disclosed in the form of quarterly reports for the last quarter of the year. Given that, such a publication does not appear to be justified.

42. Yet the main problem in the accounting for affiliated persons, which has already been mentioned, is the fact that a joint-stock company can obtain information on the affiliation of certain persons only from such persons themselves. Therefore, if they fail to perform their responsibility of notifying a joint-stock company, the company will be in no position to learn about them and, hence, to disclose this information.

4. Disclosure of Information on Major Transactions and Interested Party Transactions

43. The terms “major transaction” and “interested party transaction” were introduced in 1996 in the Federal Law “On Joint-Stock Companies.” The law set out a special procedure for such transactions.

44. Regulations on information disclosure have adopted a special approach to the disclosure of information on a joint-stock company’s transactions. Under the law, a transaction is deemed to be major if its value is in excess of 25 percent of the book value of a joint-stock company’s assets. Yet, information disclosure regulations use two different criteria a disclosable transaction must meet. The value of such transactions is to be either more than 10 percent of the value of the joint-stock company’s assets or more than 2,000,000 times the minimum monthly wage. In the Issuance Standards such transactions are described as “substantial contracts and obligations.” Another difference of “substantial contracts and obligations” from major transactions, as defined in the law, is that the former also include transactions concluded in the normal course of a joint-stock company’s business. This means that information must be disclosed not only on transactions deemed by law as major, but also on much smaller ones.

45. There is no special information disclosure requirement for interested party transactions. Yet if “substantial contracts and obligations” are at the same time considered interested party transactions, information on persons who may have interest in them must be disclosed. This approach has brought about a situation where information on interested party transactions that are worth less than 10 percent of a joint-stock company’s assets or less than 2,000,000 times the minimum monthly wage may remain undisclosed.

46. Information on substantial transactions is to be disclosed in the issuer’s quarterly reports and reports on important developments. Furthermore, quarterly reports must include information on both transactions concluded within the reporting period and transactions that are due to be concluded within 6 months after it.

47. The quarterly reports and reports on important developments are to specify with respect to each of such transactions or several interrelated transactions:

- date of signing and object of transaction(s);
- total amount (value) received (spent) by the issuer;
- the share of the issuer’s assets represented by the amount (value) received (spent) by the issuer under the transaction(s);
- full name of the company, including its organizational and legal status, postal address (with its zip code), phone number (with country and city code), fax number of the contracting party and beneficiary in the transaction.

48. Should the transaction(s) under the legislation of the Russian Federation require the consent of the issuer's authorized body, the issuer's body that granted its consent to this transaction and the date of this decision must also be specified.

5. Sanctions for Violation of Information Disclosure Rules

49. The FCSM acquired the right to impose sanctions for violations of information disclosure rules last March, when the Federal Law "On the Protection of Rights and Legitimate Interests of Investors in the Securities Market" came into force. The Law conferred on it the right to impose fines for a range of violations in the securities market.

50. The two violations that come closest to the subject under consideration are described in Article 12 of the Law: (1) failure to give an investor access to information mentioned in Article 6 of the Law (which, by the way, requires the issuer to disclose information as provided for in Russian legislation); and (2) failure to comply with the procedure and dates of the disclosure (publication) of information by a professional participant or issuer, if this disclosure (publication) requirement is provided for in the Russian legislation on securities.

51. Under the Law "On the Protection of Rights and Legitimate Interests of Investors in the Securities Market" the FCSM is entitled to impose a fine of up to 10,000 times the minimum monthly wage on issuers – and up to 200 times the minimum monthly wage, on its officers.

52. It should be noted that starting from 1999 the FCSM has been persistently exercising its authority to bring to justice those responsible for violations in the securities market. Particular attention has been paid to violations relating to information disclosure by issuers. For this reason, cases involving violations of the rules for the submission of quarterly reports accounted for a considerable share of the FCSM's caseload in 1999.