

PREFACE

In light of the growing importance of portfolio equity flows to emerging markets, the Institute, in consultation with members of its Board of Directors, invited senior executives from 16 leading asset management firms—holding about \$70 billion in portfolio equity stakes in emerging markets—to meet in January 2001 and establish the IIF’s Equity Advisory Group (EAG). The EAG, chaired by Edward Baker, Chief Executive Officer and Chief Investment Officer of Emerging Markets Equities, Alliance Capital, Ltd., is seeking implementation of its guidelines for good corporate governance in key emerging market countries that are of particular interest to the Institute’s membership base. The guidelines, which were first released in February 2002 and revised in May 2003,¹ endeavor to improve the investment climate by establishing practical guidelines for the treatment of minority shareholders, the structure and responsibilities of the board of directors, and the transparency of ownership and control of companies. The strategy for promoting the implementation of the guidelines as the standard by which the company/shareholder relationship is measured is country-focused. Country Task Forces have been set up for Brazil, China, India, Lebanon, Mexico, Poland, Russia, South Africa, Korea, and Turkey.

In September of 2002 the Russia Task Force, chaired by William Browder, Chief Executive Officer of Hermitage Capital Management, held meetings in Moscow with government officials, legislators, and members of associations and groups active in corporate governance. Following these meetings, the Task Force completed *Corporate Governance in Russia - - An Investor Perspective* in November 2002, which presented the assessments and recommendations of members of the Task Force, including a specific strategy for moving toward adoption of the IIF Code in Russia.

The 2004 Task Force report focuses on how the legal and institutional framework for corporate governance in Russia has evolved over the past two years. The aim of this report is not to provide an exhaustive due diligence of corporate governance in Russia but to offer a guidepost as to where Russia stands relative to the investment environment that members of the IIF Equity Advisory Group would like to see develop in key emerging market countries. In addition to its chairman, William Browder, Task Force members included Grant Felgenhauer, Counsel and Investment Officer, Hermitage Capital Management, Elena Krasnitskaya, Corporate Governance Analyst, Troika Dialog, and Richard Gordon and Keith Savard of the IIF staff. Meetings were held in mid-June with the National Association of Securities Market Participants (Naufor), the Investor Protection Association, the Russian Institute of Directors, the Independent Directors Association, the Moscow Interbank Currency Exchange (MICEX), the Russian Trading System (RTS), the World Bank, the European Bank for Reconstruction and Development, and a number of listed Russian companies.

¹ Investors’ poor experiences in a generally weak corporate governance environment in many emerging markets led to relatively strict and comprehensive original IIF guidelines. Nevertheless, more detailed standards were considered desirable in a few areas in light of far-reaching new legislation such as the Sarbanes-Oxley Act passed by the U.S. Congress in the summer of 2002. The revised standards offer guidance to emerging market officials as they decide what rules and regulations must be put in place to satisfy investors.

SUMMARY APPRAISAL

Corporate governance in Russia remains weak despite progress since the Task Force visit two years ago. Moreover, the Yukos affair and other recent government actions to reassert control over the energy sector have underscored the weaknesses and fragility of Russia’s institutional framework that underpins corporate governance practices. President Putin’s assurances during the past year that the government places great value on property rights and the rule of law have not been confirmed by realities of the marketplace and investors have been increasingly disturbed by the government’s heavy-handed action to seize Yukos assets for non-payment of taxes. As a consequence, investor confidence has been shaken on a scale not seen since the Russian 1998 financial crisis.

Lack of compliance by Russian firms with the voluntary Corporate Governance Code (CG Code) has been disappointing to investors. Enforcement of rules and regulations remains weak with the new Federal Service for Financial Markets (FSFM) likely to bear much of the burden of carrying out this crucial function. Despite changes in court procedures and financial assistance from international financial institutions to help promote reform, the existence of bribery, corruption, and political influence in the judicial system has led to an almost complete lack of investor confidence in the ability of the system to render a fair decision. This has been an important factor in depressing asset prices and limiting the realization of Russia’s full investment potential.

Since the November 2002 Task Force report there has been some progress in:

- The use of cumulative voting
- Improvement in board composition and management expertise
- A reduction in asset stripping by requiring shareholder approval of major asset sales (although revenue “stripping” remains a problem)
- Standardized calculation in the payment of dividends

Based on its findings, the Task Force recommends that the following improvements be given priority to help strengthen the framework for corporate governance in Russia:

- Toughen enforcement of rules on disclosure of ownership, control, and related party transactions
- Adopt International Financial Reporting Standards (IFRS) as soon as possible
- Require equal treatment in buy-out offers for shareholders in corporate takeovers
- Take further steps to prevent “forcible” takeovers or minority squeeze-outs

Awareness of the importance of good governance has gained a wider foothold in Russia over the past two years. Unfortunately however, realities of the Yukos affair including the threat of its bankruptcy if the company is stripped of its core asset, Yuganskneftegaz, have adversely influenced investor perceptions of Russia’s corporate governance environment. Although many reasons have been put forth to explain the government’s actions, it is clear that there is limited faith in the integrity of the various legal processes now engaged against Yukos and its majority owners. **The Yukos affair has not only depressed stock prices, but has**

impeded progress on corporate governance as the basic system of property and contractual rights has come under attack in the name of tax collection.

The combination of large-scale direct state involvement in the economy and persistent state corruption has been a major obstacle to improving corporate governance. In many large companies the government continues to have a significant equity stake that allows it to control the profitability of those companies through contracts, leases, and licensing agreements, often to the detriment of minority shareholders. This situation is compounded by a dysfunctional judicial system in which courts are unable to resolve minority shareholder disputes efficiently, due to, *inter alia*, heavy case loads and unskilled judges. In other emerging markets the use of non-judicial arbitration has helped to address this problem. For example, in order to list on Brazil's Bovespa stock exchange, companies are required to respect binding arbitration of disputes. Russia has also begun to use non-judicial arbitration. While the weakness of the judicial system has emerged as a general theme from the EAG Task Force, only in Russia have there been loud complaints that majority shareholders can bribe judges to take direct action against minority shareholders. **Without significant reform of the courts, minority shareholders' rights cannot be fully secure.**

Progress has been made in the separation of ownership from the oversight and management functions of private sector companies. More companies have brought in independent, professional board members, including independent board members and sometimes minority shareholder representation. **Majority owners in some of the largest companies have decided to reduce their hands-on role in company management and have hired professional management teams.** Also, many of the more egregious violations of shareholder rights have abated significantly. For example, asset stripping has declined, and fraudulent transfer pricing, while still a problem, is less of a common practice. Many of the other more aggressive displays of poor governance, including opaque or fraudulent financial statements, extreme cases of insider trading, and heavy-handed abridging of minority voting rights by majority voters have also diminished. New rules on dividend calculations and payment have improved the prospects for profit distribution. **Firms seeking access to capital markets have begun to respond to calls to improve governance practices.** This in part also reflects greater activism and influence of private sector organizations dedicated to improving corporate governance, including the protection of minority shareholder rights. Although compliance with the CG Code has been uneven at best, there is now broader-based familiarity with its content.

On the public sector side, the securities regulator has been reorganized into a new Federal Service for Financial Markets (FSFM) with expanded jurisdiction over the financial sector. The FSFM is chaired by Oleg Vyugin, a well respected professional who views corporate governance as one of the top priorities of the FSFM. Salaries of FSFM employees have been increased, but staffing and other resources remain inadequate.

Although some progress has been made in improving the infrastructure of corporate governance, Russia still has a relatively weak equity culture that tends to undervalue minority shareholders' rights. Part of the reason for this is that there has been little time for an equity culture to develop since the end of communism and the mass privatizations of the early 1990s. Ownership concentration remains high, with many of Russia's oligarchs still exercising firm control over boards. Moreover, since many of Russia's larger companies are natural

resource companies and benefit from substantial retained earnings, they are not as dependent on equity markets for financing. **As a result, market capitalization, free float, and share turnover, all remain small relative to the size of the economy.**

Although board supervision has begun to improve in a few areas, **a lack of effective disclosure of ownership, control, and related party transactions has often resulted in the enrichment of majority shareholders at the expense of the minority.** Since the time of the 2002 Task Force report there have been a number of significant corporate takeovers where minority shareholders did not receive cash buy-outs, a failure that accrued to the benefit of both the majority shareholders and the acquiring company. While the acquisition of companies through the use of intimidation backed by corrupt officials has declined, there are still examples of acquisition through the fraudulent alteration of company registers. Accounting standards and disclosure of material facts have improved, but serious discrepancies between Russian Accounting Standards and International Financial Reporting Standards (IFRS) continue to cause problems. **All listed companies will be required to adopt IFRS by 2005.**

The balance of this report will assess the key points of discussion during the meetings of the Task Force with officials and others in Russia, with particular focus on the problems that arise from concentration of ownership, the history of abuse of minority shareholder rights by majority shareholders, and the lack of effective enforcement of rules and regulations. An analysis of the Russian corporate governance framework in comparison with the IIF guidelines is provided along with an outlook of how corporate governance is likely to develop in the short to medium term.

KEY CORPORATE GOVERNANCE ISSUES

Evolving but Weak Equity Culture

Russia has a history of a weak equity culture that tends to undervalue minority shareholders' rights. One of the reasons for this is that there has been little time for an equity culture to develop during the relatively short time period which elapsed between the end of communism and the mass privatizations of the early 1990s. **Another key reason for the lack of an equity culture relates to the continuing high level of ownership concentration.** According to a 2003 report by Standard & Poors, only 6 of the 42 largest Russian companies were widely held, while 25 were controlled directly through a majority stake. In many if not most of these companies, control is exercised by a small number of so-called oligarchs who acquired state assets in the shares-for-loans privatizations of the 1990s. **Experience throughout the world has shown that whenever there is strongly concentrated company ownership, there is a danger majority owners will ignore management recommendations as well as the rights of other shareholders.**

The strong-arm tactics of the oligarchs, however, appear to be changing both for economic and political reasons. Some have come to realize that good corporate governance can help promote better company management, resulting in increased profitability. As one commentator has said, “The oligarchs grew up under Communism: they knew how to steal but not how to run a company. Now they see that they can make more money from profits than from theft.” **Since the 2002 Task Force Report, many of the oligarchs have begun to see themselves more as owners and less as managers. They have increasingly retreated from the day to day operations of the larger public companies and have sought to institute professional management teams in order to increase profitability of their firms.** Some oligarchs have also diversified their holdings away from Russian companies in order to reduce their profile vis-à-vis the current political leadership.

Good corporate governance can help protect minority shareholder interests, and contribute to the deepening of equity markets. However, in larger Russian companies there appears to be less emphasis placed on those IIF Task Force guidelines that relate directly to the protection of minority financial interests and more on those that relate to improving company structure. For example, guidelines that most directly relate to structure, like board composition and management, are relatively well followed. **Guidelines most directly related to protection of minority shareholder financial interests, such as those on disclosure of ownership, control, and related party transactions, accounting standards, and cash buy-outs during reorganizations, are generally less well observed.**

There are several reasons for the relative lack of interest by large companies in tapping equity finance. Most important, many of these listed companies are engaged in natural resource extraction and sale and are currently benefiting from high prices. The resulting revenue flows are sufficient to meet investment needs. As the Russian economy diversifies and matures, more small-and medium-sized companies without significant revenue streams are likely to need equity financing. This could also happen to large companies if natural resource prices decline sharply.

In this situation, companies are likely to be more inclined to adopt those aspects of corporate governance that protect minority shareholder interests. **It is important for the authorities to promote good corporate governance in order to attract equity investors to small-and medium-sized companies in non-extractive industries that cannot finance expansion through retained earnings. This will be a key factor in bringing about future growth in the economy and less reliance on natural resources.**

The State as Part of the Problem

Corruption by the state as a direct or indirect market participant is considered by many observers to be among the biggest obstacles to improving corporate governance.

Company directors selected by the state (in cases in which the state holds large ownership interests) have often been principals in schemes to defraud minority investors. Corruption has been prevalent in state contracting with companies as well as in licensing and other state regulatory activity. **Further withdrawal of the state from direct participation in companies' activities is key to improving overall corporate governance.**

The Yukos affair has focused much attention on the role of the state. There are several possible explanations as to the real motivations for the various government actions taken against Yukos and its majority owners, and it is fair to say that the Task Force does not know which one is accurate. **However, it is clear that there is limited faith in the conduct of the various legal actions underway against Yukos and its majority owners. Many, if not most, observers believe the process is motivated by politics.** For example, the European Commission's Director General of External Relations recently described the government's actions as, "A decision by President Putin to destroy an economic empire that had certain strategic goals of political influence . . . What's happening here is essentially a settling of accounts." A recent analysis from Troika Dialog was even more worrying for investors in other large companies, suggesting "the new era of minority shareholder risk differs markedly from the past. Then it was greedy oligarchs elbowing out minority investors. Now it is the sharp elbows of the state that are pushing minority interests aside. . . . The state may also trample minorities in its efforts to claw back assets." However, the Task Force also noted skepticism on the part of some investors as to the state's actions being construed as a plot. These investors compare the situation to a form of anarchy, with no one in full control of the legal actions against Yukos. **Whichever the explanation, few have faith in the system, and the Yukos affair has badly eroded investor confidence, resulting in a sharp drop in stock prices earlier in the year and continued uncertainty in equity markets.**

An equity culture cannot flourish if there are significant doubts about the integrity of the basic system of property and contract rights. In the case of Yukos, prosecutors, tax officials, and the courts must now work to bring closure through due process, free of political influence. In addition, the government needs to reassure investors that in the future the justice system will uphold the law and recognize corporate governance principles in a transparent manner.

New Regulator But Same Lack of Enforcement

With its establishment in May 2004, the FSFM received broader regulatory writ and greater independence from the government than its predecessor. It has, at least on paper, the necessary powers to regulate financial markets including: rulemaking, licensing, supervision, and investigation, as well as the power to issue cease and desist orders and fines for breach of laws and regulations. A good working relationship has been established between the FSFM and the corporate and broker-dealer community.

The new Chairman, Oleg Vyugin, is a highly respected public servant with excellent supervisory credentials. He has stated on several occasions that improved corporate governance will be a high priority for the FSFM. **Under its new chairman, the FSFM has taken steps to allow domestic asset managers to vote shares to improve disclosure, especially of ownership interests (reducing from 30 percent to 25 percent the ownership threshold that triggers a presumptive right to a tender offer).** In addition, the FSFM has taken steps to mandate IFRS for all listed companies and to reduce fraud in hostile takeovers by limiting the number of corporate registrars to a level that can be supervised effectively. However, more work needs to be done to implement these reforms in law.

An important issue facing the FSFM involves the implementation of Section 4, Annex I and II of Decision No. 03/54/PS of December 26, 2003. Under current regulations, the CG Code applies to all public companies on a comply or explain basis. Annex I would require that all stock exchanges (MICEX and RTS) add certain key governance rules for all A-level stock market listings, while Annex II would require a somewhat less stringent set of rules for all B level market listings.² Phase-ins over the next two years are also provided, starting in 2005.

Annex I corporate governance requirements include that:

- Boards have at least 3 genuinely independent directors
- Audit, nomination, and compensation committees be established consisting of independent directors
- There be a collective management body
- There be extensive disclosure of director's pay and other interests
- Companies have a disclosure policy
- Reports on general stockholders meetings be issued within 30 days
- Presumptive rights to a tender offer at a 30 percent ownership not be waived.

Annex II corporate governance requirements are essentially the same except that only one independent director is required and there are no rules regarding nomination and compensation committees.

² A listings require positive financial results for any two of the previous three latest years, a net asset value of more than RUR 50 million (US\$1.7 million), a six month average trading volume of RUR 1 million and a maximum controlling interest of 75 percent of voting stock. B listings require only a six month average trading volume of RUR 400 thousand (US\$13,700).

It is not yet known whether the FSFM will follow through with the implementation of Annex I and II, which are scheduled to take effect January 1, 2005. Both the MICEX and RTS have suggested that the rules may be too stringent and that compliance costs could be too high, reducing further the already thin market.

Whatever the timetable, listing requirements of exchanges and proposed FSFM regulations must be harmonized. However, both the FSFM and the exchanges lack sufficient resources to ensure compliance.

Weak Judicial System

A primary reason for the infringement of shareholders rights, as well as for other corporate governance problems, is that there have been little, if any, direct costs to the perpetrators of these actions. Effective enforcement is still lacking, whether through the regulator or through the courts. At the heart of the problem are the under-funded arbitration court system, a lack of adequately trained personnel, and the widely alleged use of bribery and intimidation to thwart justice. On a number of occasions the Task Force was told of how the judicial process had been used as a tool to deny basic investor rights, or even as a tool to harass minority investor activists. Moreover, investors have found it difficult to access information even if it is publicly available.

Some efforts are being made to rectify these problems including increased budget allocations for the judiciary to improve court and administrative procedures, some proposed changes in the Criminal and Arbitration Codes, and the sponsorship of training programs for legal personnel. However, in general there has been little progress since the 2002 Task Force visit.

Some progress has been made in creating private dispute adjudication mechanisms. Arbitration is now available through the Russian Union of Industrialists and Entrepreneurs and the Charter of Corporate and Business Ethics. **However, until the judicial system is reformed it is unlikely that there will be a significant improvement in enforcement of minority investor protections.**

Private Sector Action

Shareholders have lobbied the government and legislature for change, pointed out to management the benefits of raising asset value, and engaged in public awareness activism. The first two approaches had some success. Efforts to increase management's understanding of why good corporate governance and higher share prices are in their interest have resulted in a few high profile companies moving to strengthen their internal governance procedures.

Shareholder activism has largely taken the form of trying to expose asset stripping, revenue diversion through non-arms length related party transactions, and other abusive activities by bringing them to light in the press and by working with officials in the World Bank, the European Bank for Reconstruction and Development, and other institutions that invest money in

Russia. This approach has produced positive changes in a number of cases, especially in medium sized and regional companies. **The Russian Institute of Directors (RID) and the Independent Directors Association have raised corporate governance awareness and the RID has conducted training for directors, while organizations like the Investor Protection Association have played increasingly effective roles as advocates for investors.**

RUSSIAN CORPORATE GOVERNANCE FRAMEWORK

The foundation of corporate governance in Russia rests primarily on the Law on Joint Stock Companies (Company Law), which is supported by parts of the Securities Market Law, the Criminal Code, the Civil Code Laws on Privatization and the Administrative Code. Also of key importance is the non-binding CG Code, which applies to all listed companies on a comply or explain basis. The Russian authorities have done a thorough job at codifying key elements of corporate governance within the Company Law and especially the CG Code. Although many of the guidelines in these two documents may conform to the IIF Code, in some instances other rules and regulations exist that create ambiguities or contradictions. This can leave minority shareholders vulnerable and with limited recourse.

The analysis below compares the Company Law and the CG Code with the IIF guidelines. At the outset, it should be noted that few companies now comply with the provisions of the Code.

Minority Shareholder Protection

Russia's Company Law addresses around two-thirds of the key IIF guidelines that pertain to minority shareholder protections. The Company Law combined with the CG Code address nearly all. Scope for significant improvement lies in making mandatory tender offers for takeovers.

Voting Rights

According to Russian rules and regulations, minority shareholders have the legal right to vote on all matters of importance including mergers and the sale of substantial assets. Shareholders may vote/attend meetings both personally and by proxy. A cumulative voting procedure is mandatory in all joint-stock companies. Under company practices and policies of the IIF guidelines, cumulative voting should be permitted. There have been reports, however, that proxy voting is sometimes challenged successfully on unsubstantiated grounds. Also, shareholders holding more than 2 percent of votes are entitled to nominate a candidate to the board.

Firm Capital Structure

The Company Law requires that a majority of shareholders approve reorganization (mergers, divisions, spinoffs) and provides for the right of minority shareholders to sell shares at appraised value in the event of corporate reorganizations as provided in the IIF Code. The CG Code stipulates that anti-takeover actions that are inconsistent with shareholder interests should not be taken, which is consistent with the IIF guidelines.

In the past, Russia has had an unfortunate experience with what can best be described as the theft of companies, particularly small and regional companies, through the use of intimidation and fraud supported by bribery of local law enforcement officials. While such “hostile” takeovers are less common now, there are still examples of moves to acquire majority stakes through the fraudulent alteration of company registers or dilutive share issues. Steps have been taken by the FSFM to reduce the number of share registrars so as to allow for more effective oversight of company registries.

To address the problem of asset stripping in Russia, special rules have been adopted for shareholder approval of transactions that do not rise to the level of corporate reorganizations. The sale of more than 25 percent of a company’s assets requires either unanimous Board approval or consent of 75 percent of shareholders, and for the sale of more than 50 percent, a vote of 75 percent of shareholders is needed. Some companies set the threshold at an even lower level. In particular, Svyazinvest and its subsidiaries have internal corporate standards that require large transaction procedures for all operations with assets exceeding 0.5 percent of total asset value.

In addition, shareholders must now approve any “interested party deal” such as a loan or surety that involves 2 percent or more of the total assets of the company. While asset stripping has abated, the diversion of company revenues (sometimes called “income channeling”) is still a problem in some companies, particularly those that involve the sale of natural resources or other commodities. For example, in April 2004, Vostok Nafta Investments filed a complaint against Slavneft and its holders that it had engaged in related party transactions by income channeling profits into its subsidiary, Megionneftegaz, by selling oil at below market prices.

The CG Code requires board members to disclose related party transactions, but this provision is often ignored. This is one key area where fraud on minority investors can only be prevented by a statutory requirement. Insider trading remains a problem. Unfortunately, a law proposed by the FSFM was recently defeated in the Duma. A revised draft will be resubmitted and investors hope that it will be enacted next year.

Shareholder Meetings/Other Rights

Russian companies are generally willing to give shareholders their appropriate share of the vote, but in a number of cases management or majority shareholders have employed deceitful tactics such as moving meetings at the last minute in order to prevent shareholders from actually voting. Moreover, companies often use technical loopholes in the law to prevent outside shareholders from voting. For example, in 2001 and 2004 Gazprom used legal proceedings to freeze foreign investor’s shares in order to block voting rights immediately before general shareholder meetings, citing a 1997 law restricting foreign ownership.

The Company Law provides general requirements for shareholder meetings, while the CG Code outlines in detail a number of procedures for conducting a meeting. It recognizes the importance of giving timely notice of a meeting, and the recommended 30-day notice before each meeting is an improvement over the 20-day notice mandated by law. The CG Code includes a precise formulation of meeting agenda items, which are aimed at preventing multiple interpretations. It even goes so far as to recommend that such words as “other” and

"miscellaneous" should not be used to identify agenda issues. A detailed discussion is provided in the CG Code on the selection of the place, date and time for the general shareholders' meeting. For example, the CG Code recommends that the annual general shareholders' meeting should commence not earlier than 9 a.m., and not later than 10 p.m. local time. As a best practice, the IIF guidelines require that a meeting notice and agenda be sent to shareholders at least one month prior to a meeting.

Structure and Responsibilities of the Board of Directors

Russia's Company Law complies with about two-thirds of the IIF guidelines pertaining to boards of directors. The Company Law combined with the CG Code address nearly all. Scope for significant improvement lies in enforcing disclosure requirements of related party transactions.

Board Structure

Amendments to the Company Law adopted in the Spring of 2004 have created a number of key improvements relative to the 2002 Task Force report. A new requirement is that all companies have a minimum of 5 directors, that companies with 1,000 or more shareholders have a minimum of 7, and that companies with 10,000 shareholders or more must have a minimum of 9. All directors must be elected through cumulative voting. This combination has made it far easier for minority investors to elect representatives to boards of listed companies. In several high-profile cases these directors have played an important role in protecting minority shareholder rights, including by monitoring related party transactions and overseeing auditors.

Under the Company Law, executives should not form the majority on the board of directors. Moreover, under the Company Law, a company's CEO cannot be chairman of the board. The IIF guidelines state that at least one-third of the board should be non-executive. A survey of companies conducted by the Russian Institute of Directors showed that more than two-thirds of the members of boards of directors were non-executive. The IIF guidelines call for a majority of independent directors as a best practice, while the CG Code states that the number of independent directors should be three or at least one-fourth of the board. While this provision has not yet been widely followed (only about a third of listed companies now have independent directors, and most of those only have one), many of the largest companies now have three, and the trend has been towards increasing numbers of independent directors. At the same time, there have been some unsettling and notable exceptions to the generally positive trend. For example, at its 2003 Annual Shareholders meeting, Gazprom elected no independent directors, and in 2004 CT-mobile, currently controlled by Alfa, voted to ignore a Stockholm Arbitration Court ruling and elect two persons to the Board of Directors of MegaFon (which Alfa also has a minority interest in) who were found to be connected to Alfa.

The definition of independence put forth in the CG Code contains seven criteria that help define an independent relationship from a business perspective. However, in practice, the relationship between managers, controlling shareholders and board members is often very close. Board members are often selected by controlling shareholders and are under their influence, even if they "qualify" as independent directors based on the CG Code checklist. The IIF guidelines require that independent directors do not have any business or personal relationship with

management or the company. Moreover, an independent director cannot be a controlling shareholder.

As in other emerging markets, the eligible pool of candidates who could serve as independent directors is very limited. However, organizations such as the Independent Directors Association and the Russian Institute of Directors have stepped up their training, and many larger companies, have relied successfully on expatriates.

The CG Code recommends that audit, nomination, and compensation committees be comprised of independent directors, which is in line with our own recommendations. Once Annex I becomes effective, listed companies will be required to have these committees filled with independent directors.

Disclosure and Other Responsibilities

The CG Code articulates the main principles of information disclosure such as regularity, availability to the majority of shareholders, reliability, and completeness. It outlines specific guidelines for disclosure of a company's dividend policy, management structure, and stock activities of major shareholders. However, another key disclosure principle, stipulating a necessary balance between transparency and the protection of a company's interest, creates a substantial loophole that casts doubt on the reliability of the intervention that is provided. Moreover, Russian law is generally viewed as lagging far behind the CG Code regarding disclosure requirements. On balance, the intent of the CG Code seems to be in keeping with the IIF guidelines, which call for the disclosure of all material information, defined as any information that could affect share price.

A key corporate governance problem identified by the Task Force has been non-arm's length related party transactions. Soon after the large-scale loans-for-shares privatizations, Russian companies became well known for instances of asset stripping, primarily through non-arm's length related party transactions. This problem has abated considerably, in part through changes in the CG Code relating to shareholder approval of major transactions, but instances of abuse remain.

Accounting/Auditing

Russia's Company Law addresses about two-thirds of the key guidelines defined by the IIF's EAG that pertain to accounting and auditing. The Company Law combined with the CG Code address three-fourths. Significant improvement could be realized through the adoption of IFRS.

Standards

The CG Code details auditing control but not compliance with accounting standards. This reflects the difficulty in revamping accounting standards. The 1998 Russian Accounting Reform Program envisaged an evolving Russian Accounting Standards (RAS) system, which would move closer to IFRS. However, progress has been slow. Issues of changing taxation provisions and separating tax from financial reporting accounting have posed serious problems.

The CG Code deals with the issue of standards by stating that independent audit organizations should certify compliance of a company's financial reports with Russian accounting standards. If a company is willing to enter international markets and undertakes to follow international financial reporting standards, then audits will test compliance with such international standards. The FSFM has announced that it will seek to impose IFRS on all listed companies in the near future.

Audit Board/Audit Committee

The Company Law provides for a separate auditing body, the Audit Commission that is separately elected by shareholders. The Audit Commission, which may consist only of people who are not also members of the board or management, oversees the activities of the external auditor. It reports directly to shareholders. The CG Code also calls for an Audit Committee of the Board. The Code recommends that the Audit Committee oversee all audit activities and report to the full board. It should include only independent directors, but if for objective reasons this is impossible, the audit committee should be headed by an independent director. This recommendation exceeds that included in the IIF Code.

Accounting and auditing irregularities, however, continue and shareholders have difficulties in finding proper recourse. For example, one shareholder was unable to sue an auditor, who knowingly provided false information about a company, because it was determined that the shareholder did not have a direct business relationship with the auditor.

Transparency of Ownership and Control

Russia's Company Law addresses roughly two-thirds of the key IIF guidelines that pertain to transparency of ownership and control. The Company Law combined with the CG Code address nearly all. There is significant scope for improvement in the area of disclosure rules.

Russian rules and regulations concerning transparency of ownership and control are consistent with the IIF guidelines. Under Russian law shareholders must disclose acquisition of 30 percent or more of outstanding shares of a company, as well as each incremental transaction of 5 percent. The CG Code recommends starting disclosure with shareholdings of 5 percent.

The Company Law provides that when a 30 percent ownership threshold is reached a tender offer is required for the remaining shares (the FSFM has recently proposed extending the rule to the acquisition of a 25 percent stake). However, this requirement can be waived by the company. The best practice under the IIF guidelines calls for a buyout offer when ownership exceeds 35 percent. The CG Code states that relieving the new owners of the duty to buy out the remaining shareholders by resolution of the general shareholders meeting or by the charter of the company is undesirable, in the majority of cases, and is not recommended.

However, the record to date in this area has not been encouraging. Unlawful transactions with interested parties are a serious problem in Russia. "Closed subscriptions" at below market prices to affiliated parties or placement terms set to prevent existing shareholders from acquiring new shares or to make such acquisitions as difficult as possible, have been common violations in

Russian companies. Moreover, requirements for disclosing ownership are scattered among different laws and regulatory acts. These requirements are sometimes contradictory, or at least not fully consistent. For example, some requirements consider the percentage of authorized capital, while others look at the percentage of votes.

Going forward, it is essential that the ownership and control structure of a company remain fully transparent to all shareholders under all circumstances. This is crucial in order for outside shareholders to properly assess how control is exercised and to evaluate their own position and interest in providing equity finance. As discussed earlier, disclosure of ownership and control structures is key to effectively addressing questionable related party transactions, insider dealing and conflicts of interest, which are the most widespread and pernicious infringements of shareholder rights.

Regulatory Environment

Russia's corporate governance institutional framework addresses the key IIF guidelines that pertain to regulatory issues. The most significant problem is the lack of effective enforcement.

The FSFM has primary oversight, regulatory, and enforcement responsibilities for governance issues. While the new Chairman of the FSFM is praised for his integrity and professionalism, the agency is significantly understaffed and needs additional resources to improve enforcement. The MICEX and the RTS have the authority to suspend the trading of securities or cancel a trading license for violation of any mandatory rule, but they have only limited resources for investigation and enforcement.

The FSFM is empowered to investigate, judge, issue cease and desist orders, and punish through the application of fines and suspension of licenses any irregularity due to an infraction of mandatory rules, as well as that might occur in the securities market. In the event of any suspicious activities, the FSFM may initiate an administrative inquiry to collect information, formal statements, and material evidence aiming at the identification of responsibility. Appeals of decisions lie with the arbitration court.

OUTLOOK AND RECOMMENDATIONS

Although there are severe shortcomings in Russian corporate governance, the efforts of both the FSFM and the private sector to move forward on a number of fronts to improve actual practices are welcome. However, true progress in promoting good corporate governance in Russia will be measured by consistent and concerted actions to provide legal relief and enforcement of judgments against companies and management that violate shareholders' rights. The Russian authorities are receiving outside assistance to help strengthen enforcement procedures, and are aware of the need to press forward on efforts to reform the arbitration courts.

Progress in improving those aspects of corporate governance that protect minority investors will depend in part on further change in the corporate mindset in Russia. **Corporate governance is not part of business ethics and will likely remain a public relations exercise**

until an equity culture takes hold and the enforcement of laws and regulations becomes the norm. In particular, efforts are needed to convince company executives that there are benefits to tapping capital markets for equity financing, and that exercising good corporate governance to improve minority shareholder value will reduce the costs of such financing. In this connection, the Task Force welcomes the authorities' efforts to move minority-squeeze-out legislation modeled after Delaware standards through the Duma, but the enforcement powers of the FSFM as well as the even-handedness of the judicial system need to be enhanced in order for the law to become an effective and reliable protector of minority rights.

It is likely that the primary impetus to push for better corporate governance will continue to come from the domestic and international investors seeking opportunities in Russia. Investors have bonded together to lobby for enforcement of their rights. They should continue with this approach and also take every opportunity in shareholder meetings to exercise their rights, including electing independent members to the boards of directors.

Given the organized and active investor base in Moscow, the Task Force recommends continuing to work with private sector groups dedicated to advancing good corporate governance and to protecting shareholder rights. In particular, the National Council on Corporate Governance, the Russian Institute of Directors, the Independent Directors Association, the Association for the Protection of Investor Rights, and the Organization for the Protection of Investor and Shareholder Rights should be encouraged to promote the adoption of IIF guidelines for good corporate governance. **The Task Force also recommends that Russian pension funds and asset management firms become more closely involved in encouraging the wider dissemination of the IIF guidelines.** Although pension funds and asset management firms are still at the early stage of development and are currently restricted by law from exercising full shareholder voting rights, they have a vested interest in advocating good corporate governance as equity holdings become an important part of their portfolios. These firms will necessarily gain the attention of the public and politicians as they begin to accumulate assets and will likely have a strong voice in demanding transparency and soundness of the financial system.

The Task Force recommends that the following priority actions on governance be implemented as soon as possible by the FSFM:

- Toughen enforcement of rules on disclosure of ownership, control, and related party transactions
- Require disclosure of director's pay and other interests (as found in the CG Code, Annex I)
- Require audit, nomination, and compensation committees consisting of independent directors (as found in CG Code, Annex I)
- Adopt International Financial Reporting Standards as soon as possible
- Require buy-out offers for shareholders in corporate mergers and takeovers (as found in Annex I)
- Take further steps to prevent "forcible" takeovers or minority squeeze-outs

The following broad-based measures by the Russian authorities would also strengthen the governance framework:

- Provide additional oversight and training for arbitration court judges

- Support additional training for independent directors
- Provide additional resources to the FSFM for investigations and prosecutions

In addition, in light of the turmoil caused by the Yukos affair, it is essential that the authorities provide clear and convincing proof of the integrity of the tax and legal system and that their operations will be free of political considerations.

APPENDIX

**Comparison of the IIF Code
and
The Federal Law on Joint Stock Companies (CL)
and
The Corporate Governance Code (GC)**

Topic	IIF Code Recommendations	The Federal Law on Joint Stock Companies (CL)
		The Corporate Governance Code (CG) (where different from CL provision)
Minority Shareholder Protection		
Voting rights		
Proxy voting	Firms are encouraged to allow proxy voting.	Proxy voting is allowed (CL Art 57, Sec. Dec. No. 17/PS).
One share one vote principle	“One share one vote” should be a threshold requirement for new issues.	Each common share carries the same voting rights (CL Art. 31, 49, 59) but non-voting preferred stock is also allowed (CL Art. 32). Preferred stock carries the right to vote in matters of company re-organization or liquidation (CL Art. 32).
Cumulative voting	Cumulative voting should be permitted.	Cumulative voting is required for elections to the Board (CL Art. 66).
Capital Structure		
Takeover/buyout/merger Procedures	<p>Shareholder approval of takeover/merger should be required.</p> <p>If an offer is made above a reasonable minimum threshold of outstanding stock, a significant portion of that purchase must be through a public offer.</p> <p>Under a merger/takeover, minority shareholders should have a legal right to sell shares at appraised value.</p> <p>Anti-takeover measures should be approved by shareholder vote.</p>	A 75 percent majority shareholder approval is required for a reorganization (including a merger, division, accession, transformation) or large scale transaction) CL Arts. 15-20, 48). A 75 percent majority shareholder approval is required for a “large scale transaction” defined as the acquisition or sale of assets equal in value to 50 percent or more of a company’s appraised assets. It is also required for assets equal in value between 25 percent and 50 percent if the vote of the Board is not unanimous (CL Arts. 48, 49, 52, 78, 79). Shareholders who did not vote in favor have a right to sell shares to the company at independently appraised value (CL Art. 75).
Anti-dilution measures	Dilution of voting or ownership rights should not be permitted without a majority vote by all shareholders. Any dilutive activity should apply <i>pro rata</i> across all shareholders.	A minimum of a 75 percent vote of both, shareholders and preferred stockholders, is required to change ownership rights of the affected preferred stock (CL Art. 32).

Capital increases	Shareholder approval is required. Any capital increase, over a period of a year and above a minimum threshold, must first be offered to all existing shareholders. There should be constraints on sales to the majority shareholder group.	A majority shareholders' vote is required to issue additional shares unless the right is given to directors by company's articles, in which case it must be adopted unanimously. (CL Art. 28, 48, 49). Shareholders have the right to participate in public subscriptions to their company's new shares. They may purchase additional shares in amounts proportional to the number of shares already held in the same class or category (CL Art. 40).
Shareholder meeting		
Meeting notice and agenda	Meeting notice and agenda should be sent to shareholders within a reasonable amount of time prior to meetings.	Must be 20 days in advance, or 30 days if reorganization is proposed (CL Art. 52). Should be 30 days in all cases (Ch. 2).
Special meetings	Minority shareholders should be able to call special meetings with some minimum threshold of the outstanding shares.	Ten percent of shareholders may call a special meeting (CL Art. 55).
Conflicts between shareholders	Should have mechanism where a minority of shareholders can trigger an arbitration procedure to resolve conflicts between minority and controlling shareholders.	No provision. Company should facilitate resolution of conflicts (Ch. 10).
Share blocking	Should provide for a registered date before meetings that assign the voting rights of a share to the current owner.	Voting right must be assigned prior to a meeting (CL Art. 51).
Quorum	Should not be set too high or too low. Suggested level would be about 30 percent and should include some independent non-majority-owning shareholders.	A majority of votes of floated shares for first meeting, 30 percent for adjourned meeting. Smaller quorum may apply for companies with fewer than 500,000 shareholders (CL Art. 58). For companies with over 500,000 shareholders, should be 20 percent for adjourned meeting.
Petition rules/objection to majority shareholder actions	Minority shareholders should have the right to formally present a view to the board if they own some predefined minimum threshold of outstanding shares.	Two percent of voting shares required to put item on agenda of a general meeting (CL Art. 53).
Structure and Responsibilities of the Board of Directors		
Board structure		
Definition of independence	Cannot have a business or personal relationship with the management or company, and cannot be a controlling shareholder such that independence, or appearance of independence, is jeopardized.	No definition. Covers all business and personal relationships with major stockholders, management, and company. Must have served on Board for less than 7 years (Ch. 3).
Share of independent directors	At least one-third of the board should be non-executive, a majority of who should be independent. Best practice that a majority of the board should be independent.	No more than 25 percent of the board may be executives (CL Art. 66). Independent directors should comprise at least 25 percent of board, and company charter should include requirement that there be at least 3 independent directors (Ch 3).
Frequency and record of meetings	For large companies, board meetings every quarter, audit committee meetings every 6 months. Minutes of meetings should	Meetings convened by chairman, by request of any board member, auditor or audit commission (CL Art. 68).

	become part of public record.	Meetings at least once every 6 weeks. Meetings part of public record. (Ch 3).
Quorum	Should consist of executive, non-executive, and independent non-executive members.	Quorum is majority of all members (CL Art. 68).
		Quorum should be specified, but preferably at least two-thirds (Ch 3).
Nomination of directors	Should be done by nomination committee chaired by an independent director. Minority shareholders should have mechanism for putting forward directors at Annual General Meeting (AGM) and Extraordinary General Meeting (EGM).	Two percent of voting shares needed to nominate a director (CL Art. 53).
		Directors nominated by human resources and remuneration committee (covers both nomination and compensation), chaired by independent director. If possible all members should be independent (Ch. 3).
Term limits for independent Directors	For large companies, reelection should be every 3 years with specified term limits.	No provision.
		Independent must serve less than 7 years (Ch.3).
Board committees	The Board should set up 3 essential committees: nomination, compensation and audit.	Must have a separately elected statutory audit board (CL Art. 85).
		Must have human resources and remuneration committee (covers both nomination and compensation), and audit committee (Ch. 3).
Formal evaluation of board members	For large companies, nomination committee must review directors ahead of formal re-election at AGM.	Nomination committee reviews directors before AGM (Ch. 3).

Disclosure		
Remuneration of directors	Should be disclosed in annual report. All major compensation schemes, including stock options, should be fully disclosed and subject to shareholder approval.	Remuneration subject to shareholder approval (CL Art. 64).
		Annual report should disclose evaluation of performance of directors and information on total of all forms of compensation (Ch. 3).
Other responsibilities		
Conflict of interest	Any potential or actual conflicts of interest on the part of directors should be disclosed. Board members should abstain from voting if they have a conflict of interest pertaining to that matter.	Full disclosure of any real or potential conflict of interest, must refrain from voting in the event there is an actual conflict (Ch. 3).
Investor relations	Should have an investor relations program.	Should have a company regulation on information policy, have regular meetings with shareholders and disclose relevant matters (Ch 7).
Social responsibility and ethics	Make a statement on policy concerning environmental issues and social responsibility.	“May” establish an ethics committee (Ch 3).
Accounting/Auditing		
Standards		
National/international GAAP	Identify accounting standard used. Comply with local practices and use consolidated accounting (annually) for all subsidiaries in which sizable ownership exists. Off balance sheet items should be disclosed in accordance with usual reporting style.	Auditor must conform with Russian accounting practices, which includes consolidated accounting and disclosure of off-balance sheet items (CL Art. 85-87).
Frequency	Semi-annually audited report at end-FY.	Annual audited report required (CL Art. 88).
		Should disclose quarterly reports (Ch. 7)
Audit quality	Independent public accountant. As a best practice, auditors should adhere to the global standards devised by the International Forum on Accountancy Development (IFAD).	Independent auditor required (CL Art. 86).
		If the company wishes to enter “international markets” it should comply with IFRS (Ch 8).

Audit committee		
Audit committee	For large firms, must be chaired by qualified independent director.	Must have a separately elected statutory audit board consisting of members who are not board members of managers (CL Art. 85).
Financial background	Must be chaired by qualified independent director with a financial background.	Audit committee of the board should include only independent members if possible; if not, it should be chaired by an independent member and include only non-executive members. Members should be qualified in financial matters (Chs. 2, 8).
Transparency of Ownership and Control		
Buyout offer to minority Shareholders	Ownership exceeding 35 percent triggers a buyout offer in which all shareholders are treated equally.	Shareholders must disclose acquisition of 30 percent of a company plus each additional 5 percent. Thirty percent triggers a buyout offer, which can be waived by resolution of the general shareholders meeting or by the charter of the company (Art. 80).
		Waiver the duty to buy out the remaining shareholders is undesirable “in the majority of cases” and is not recommended. (Ch. 6).
Related-party ownership	Companies should disclose directors’ and senior executives’ shareholdings, and all insider dealings by directors and senior executives should be disclosed.	All company deals (including loans and surities) involving a director, manager, or 20 percent or more shareholder, plus all related parties must be disclosed to the board, to the audit commission, and to the auditor. Deal must be approved by a majority of disinterested and independent directors, unless the deal is worth 2 percent or more of the assets of the company, in which case a majority of (disinterested) shareholders must approve (CL Art 84).
Minimally significant Shareholders	Shareholders with minimally significant ownership (greater than 3-10 percent) of outstanding shares must disclose their holdings.	No provision.
		Shareholders should disclose acquisition of 5 percent or more (Ch 7).
Regulatory Environment		
Enforcement powers	The exchange should have the power to grant, review, suspend, or terminate the listing of securities. Enforcement authorities must have an adequate training and understanding of the judicial process.	Exchange has powers to grant, review, suspend, terminate listings, but do not have adequate staff for investigations. Enforcement authorities are under-trained and understaffed.
Oversight	The exchange should be independent from industry and the government.	Exchanges are independent.



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