

**1<sup>st</sup> Session «Public Sector: Restructuring strategies, consequences – trends, evaluation»**

**Corporate Governance Reform in Russia: Possibilities of Using EU Experience**

Ekaterina M. Panina  
Moscow State University, Russia.

**Abstract**

This paper examines corporate governance reform in Russia, its goals, problems and perspectives. The main problem of reform is the state regulation of corporate governance and corporate law, so the paper analyzes the possibilities for Russia to draw on European corporate reform experience, because Russian law system is mostly similar to European. In the same time, there are a lot of differences which can embarrass an implementing of EU corporate governance model in Russia.

Good corporate governance helps to ensure that companies use their resources more efficiently and leads to more competitive companies and better relations with shareholders and stakeholders, such as creditors and employees. Most importantly for a transition economy like Russia, good corporate governance enhances the confidence of domestic and foreign investors and helps to attract the long-term investment needed to sustain economic growth. The problem of corporate governance, which involves balancing the interests of various groups of stakeholders (shareholders, including large shareholders, minority shareholders, holders of preferred stock, a company's managers and its employees, government agencies), is a pressing one for most of the countries of the world.

International organizations have also focused their attention on the matter of developing corporate governance standards. For example, in May 1999 an OECD council approved the Principles of Corporate governance, which are non-binding and are intended to serve as a sort of reference point for the creation of a legal basis for

corporate governance at the government level, and also for a company's evaluation and development of its own practices. The document outlines principles pertaining to five areas:

- the rights of shareholders;
- equitable treatment of shareholders;
- the role of stakeholders in management of a corporation;
- disclosure and transparency; and
- the responsibilities of the board of directors.

There have also been initiatives to improve corporate governance from the government, regulators and various private agencies. The government is adopting new laws and amendments to the existing laws. In 2002 Russia introduced a Corporate Governance Code developed with EBRD technical assistance and financial support from the government of Japan.

Independent directors as a category have appeared in Russia. For example, LUKoil bylaws require that there should be at least three independent directors on the board. There are three independent directors on Norilsk Nickel's board. Other companies have announced similar decisions. The institution of independent directors is already working and in some cases has even led to conflicts when independent directors opposed dubious or non-transparent deals made by the leaders of their companies.

A certain regulatory base has been laid in Russia for the activities of the independent directors. In particular, the Russian Association of Independent Directors has drawn up an Independent Director Code. The code's provisions, like those of the Corporate Governance Code, have imposed tough requirements (similar to those adopted in the United States) on the independent directors. Along with formal requirements, an independent director must obviously be a professional – only in this case he will be able to properly supervise the company's activities and take part in the drawing up of its strategy.

These changes helped Russian companies to shift to modern corporate governance standards. The main obstacle was their mistrust of the state: greater transparency would require companies to pay more taxes; it would make them vulnerable before

government agencies and rivals through various manipulative administrative levers. But the tax reform and stronger political stability allow some large companies to shift to modern standards of corporate governance.

The further enhancement of market relations in Russia demands significant development and modernization of the currently existing rules and principles of corporate law. Many of them, as currently fixed in legislation and subsequently further developed by judicial practice, do not ensure proper protection of the interests of market participants, first of all for investors and creditors. The reformation of corporate law is an important condition for long-term economic development and for better economic cooperation between Russia and other countries of the world. Reformation of the legislative system should be undertaken based upon an analysis of business relationships, the existing regulations, the history of their development and the practice in applying them, taking into account international experience in adapting basic rules and legal principles. The strategic goals that should be followed by corporate reform are as follows:

- improvement of financing opportunities for companies;
- de-bureaucratization;
- protection of market participant interests;
- flexibility;
- clarity and transparency in decision making
- Public discussion of corporate governance problems

The Russian market's internal financial resources are limited; domestic companies increasingly seek Western investors and lenders which until recently turned a blind eye to Russian companies' insufficient financial transparency and underdeveloped Russian corporate governance. It is commonly held that the low level of financing available for many Russian companies, in particular those of medium size, prevents them from achieving maximum growth levels. In fact, for such companies, lack of financing is a competitive disadvantage for expanding their activity both inside and outside Russia, which has a negative effect on the Russian economy as a whole.

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Therefore *the first goal* of the reforms is to increase the viability and stability of all kinds of financing. The reforms which took place at the beginning of the 21st century focused on reducing what have been seen as bureaucratic obstacles to the development of corporate activity. This approach should be encouraged, as a rapidly developing economy needs to provide an adequate base for changing corporate models. Furthermore, inasmuch as in the Russian economy the majority of participants have little experience in solving corporate problems, it is advisable to give them the opportunity to easily carry out changes in their own corporate models and structures for the further development of their business. Thus, *the second goal* is de-bureaucratization, the elimination of administrative norms that block the activity of the company. Corporate law should provide not only a special set of methods for protecting the rights and interests of all market participants, but also the possibility for them to choose specific measures for protecting their rights. *The third goal* consists in increasing effectiveness and evaluating the applicability in practice of specific methods of protection aimed at enhancing confidence on the part of market participants.

When developing an approach to the main principles of reform, the legislator should be flexible and take a long-term view. In particular, it is necessary to evaluate constantly how great the danger of abuse of the principles is, and develop the corresponding legal means of protection against such cases. So *the fourth goal* of the reforms should be flexibility in the development and passing of legislative innovations. *The fifth goal* therefore is clarity and transparency in decision-making. The factor of uncertainty plays an especially negative role in corporate law which is often not taken into account at all during discussions of reform. Finally *the sixth goal* is open discussion of corporate governance and its problems and popularizing principles and best practice of effective corporate governance among the shareholders and managers.

Reform would allow the solution of a number of important challenges, including:

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- eliminating many rules which block the development of the business of Russian companies and increasing the efficiency of financing Russian business;
- securing an adequate level of protection of the rights and interests of stakeholders;
- achieving reliability and stability in legislation in the area of corporate law and governance.

The problems of perfecting legislation are closely connected to those of enforcement. In discussions about corporate reform, this aspect is especially important, since it focuses attention on such urgent issues as overcoming corruption and the independence of the judicial system. In conducting reforms and in harmonizing the corporate legislation of Russia and the EU countries, it is necessary to consider both the current possibilities of state authorities and the clear definition of their powers and functions.

Measures undertaken should assist in the strengthening of the role of the state in the regulation of corporate governance issues, including raising the qualifications and enriching the professional experience of representatives of all branches of government. In many cases, the attitude of registration bodies towards the disclosure of information does not lead to the attainment of any of the main goals of this element of corporate relations. In particular, the following issues must be addressed by legislation:

- In the case of real estate registers, it is unclear whether the acquisition of property will be considered to have been made in good faith if incorrect information was submitted and published.
- Entries in securities registers are made in such a way that it is very difficult to establish the legal effect they have, or to determine the consequences in a case when a person who is acting in good faith relied upon an entry in a securities registry. There is also no clear definition of liability if an issuer presents incorrect information. Here it is worth noting that in Russia a serious discussion on the issues of liability for the disclosure of incorrect information in securities prospectuses has not yet begun. This discussion has taken place

in European countries and the views stated during it have been reflected in the unified law of the EU.

- The legal consequences of transferring a shareholders' register to another registrar are poorly regulated. Although changing the name of the owner of shares in a register plays a critical role in transferring ownership of shares, a number of items related to the procedure for the transfer of shares from one register to the other register is unclear. It is necessary to provide a clear procedure for transferring a shareholders' register to another registrar.
- A simple dispute about the legitimacy of the appointment of a general director can go on for many months. The state register of legal entities plays a large role in the registration of changes, but in fact gives weak guarantees regarding the authority of persons registered in the registry to represent the company. Using the experience of the European registration system, which requires the registration of persons who have the authority to represent the company, could noticeably speed up the resolution about the issue of the authority of a general director and the legitimacy of his appointment.

A significant portion of the recommendations proposed recently is directed at strengthening the regulatory, supervisory and control functions of the state regulator, the FSFM. The essence of these proposals is that in order to effectively implement the functions indicated, it is necessary to create a single state regulator in the financial market which has a special status (for instance, assigning such a status to the FSFM). In practice this requires the operational independence of the regulator, subordination to the chief executive of the state, collegial bodies for governing and decision-making, and financial autonomy. In order to realize these proposals, the conduct of reforms of regulatory systems in the financial markets was considered through the development of special legislation defining the authority, status, and decision-making system of the body authorized to conduct regulation and control in the financial market, and to perform services for its participants. This would enable the most effective protection of the rights and lawful interests of investors in the financial market and would provide a more effective oversight of the established requirements and rules.

The realization of these proposals would give the FSFM powers similar to the powers of comparable regulatory bodies in Western countries. The efficacy of using such powers depends directly on the speed of reactions of the regulator to market developments, undesirable conduct by its participants, and also on to the extent that its activity meets the requirements of middle-sized business. This raises the question of the advisability of a general strengthening of the role of state bodies. The ability of self-regulating organizations to provide a reliable regulation and supervision of the securities market in Russia is doubtful unless a systematic approach is taken towards regulation, especially taking into account the relatively low degree of organization of participants in the securities markets, and the fact that they are split into banks and entities subject to supervision by the FSFM as well as the problem of imposing personal liability on the managers of companies. On the other hand, the weaknesses of state bodies make the proposition of handing over certain state functions to self-regulatory bodies quite attractive, and there are ongoing discussions about such a transfer. Generally, even in countries such as Germany where state regulation is quite developed, the role of banking associations in deposit insurance and of stock exchanges in supervising and adapting disclosure rules is far greater than in Russia. The conduct of control functions must be tied to the disclosure of information on securities, thereby enhancing the level of generally available information about the company as a whole. There should be particular focus on the disclosure of information by state authorities, as there have been some cases where information has been disclosed by state authorities in an informal manner, leading to a loss of credibility on the part of companies and investors. The development of the functions of state regulatory bodies relying on tried-and-tested world practice would enable a fuller integration of Russia into the international contractual-legal system. Where authority is delegated to private self-regulating organizations, they should be able to compensate the damage to securities market participants as the result of the unconscientious performance of its duties, for instance, through establishing a minimal level of registered nominal capital to be maintained during the existence of the company which is allocated to a special reserve established to compensate for damages. It is likewise possible to introduce mandatory insurance of the professional

liability of such an organization. This requirement should safeguard investors and ensure that private entities comply with legislation and the main guidelines of the self-regulating organization. When negotiating an insurance policy, insurance companies assess the risk of the insured event happening and establish requirements for minimizing the risk which the insured must fulfill under the insurance contract. Additionally, it may be required that the losses incurred by a securities market participant related to the actions of a self-regulating organization be paid for from funds set aside by this organization.

**The Russian corporate environment is characterized by high ownership concentration in firms, especially in the hands of insiders, weak legal institutions that lead to high private benefits of control, underdeveloped capital markets, a segmented labor market, and significant involvement of the state in business.**

These features make the focus of the debate on Russian corporate governance substantially different from the one in the developed market economies, especially the Anglo-Saxon countries. The main conflicts of interest in Russian firms are between large and small shareholders, rather than between a manager and a large number of dispersed shareholders, as in the US or UK. On top of that, large owners are often in conflict amongst themselves, and with outside raiders who are attracted by possibilities to seize assets. Yet, there is another “layer” of conflict: the one between the state and private business, whose objectives may diverge substantially. Recently, government intervention into business has become very significant. A number of large companies moved under state control, others have been accused of tax avoidance and received large claims for unpaid taxes from the tax authorities; and the government has also tried to exclude foreigners from participation in large profitable businesses, such as oil extraction.

The classical mechanisms of corporate control have been working poorly in Russia. For example, in most companies the board of directors represents the interests of the executive bodies, not shareholders. Besides, the CEOs of some privatized enterprises have a strong dislike for control by the shareholders. Such companies usually lose competitive advantages, therefore there are increasingly fewer managers who hold such views.

Another factor that played a negative role in the development of corporate relations was the unceremonious methods used by majority owners to increase their stakes and thus consolidate equity control. This led to frequent breaches of minority shareholders' rights and earned Russian businesses a bad reputation. But cases like these are rare in Russia now, as few Russian businessmen wish to have their reputation stained. Furthermore, respective amendments have been made to the legislation which regulates such activities.

It is necessary to remember that whilst Russian national developments have been similar to developments in European law in a number of areas, in other areas European law developments have been anticipated by national legislation. This is the case for mandatory accounting. Similarly, it is only recently that liability for prospectuses has been introduced into European law. Also, European law presupposed the existence of an audit profession with a substantial degree of independence, which it then further regulated.

European law may be a good model for reform in Russia, but the reform measures need to be introduced with some care. The continental system has a strong tradition in Russia, which started long before the revolution. This tradition has been revived by the new Civil Code, and is also dominant in teaching at universities and academic writing, forming the basis of education and decision-making by judges. Even if one came to the conclusion that the continental system of corporate law is weaker than the Anglo-Saxon one, it would neither make sense nor be realistic to reverse the already strong tendency to continue the continental law approach dominating in Russian civil law, as this would require a completely different mindset of judges and lawmakers. Also, a system that relies heavily on common sense providing a consensus on what is appropriate behavior in each case is not likely to be viable in a jurisdiction where there are a wide range of diverging opinions, where players and regulators are suspected of being subject to undue influence and where standards change very quickly. The focus of reform proposals should therefore be to develop general rules and delineate authority as clearly as possible so as to enhance predictability.