



CORPORATE GOVERNANCE IN RUSSIA ANALYTICAL REPORT

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Abstract

The paper considers corporate governance practices in Russia. Market and information infrastructure, legal environment, regulatory environment are investigated. The level of corporate governance in Russia remains low. The vast majority of Russian companies still lack transparent operational and ownership structures, and suffer from weak internal control procedures. The redistribution of ownership stakes, the introduction of strategic shareholders -- often in conjunction with significant investments -- and the desire to attract outside capital are major driving forces in the improvement in governance standards in Russia.

Keywords: corporate governance, ownership structure, internal control

Introduction

Despite significant improvements over the past several years, the level of corporate governance in Russia remains low. The vast majority of Russian companies still lack transparent operational and ownership structures, and suffer from weak internal control procedures. Affiliate party dealings are common, and there are many opportunities for the abuse of minority shareholders.

Legacy is partly to blame. The consolidation of ownership in Russian corporations following the Russian mass privatisations of 1992-1995 was accompanied by corporate "wars," and the weapons were false bankruptcies, improper notification for shareholder meetings, arrests of shares via suits filed by individual shareholders to prevent some owners from attending shareholder meetings, and discriminatory treatment of various shareholders.

During the Russian economic crisis of 1998, following the government's default on its domestic debt, many of the largest banks collapsed, with their owners stripping them of their assets. Meanwhile, the majority of foreign investors pulled out of the Russian market. In recent years, however,

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foreign direct and portfolio investment has begun to return, though with increased caution and upon the condition of improving corporate governance.

The Russian government and international organizations have put forward a number of initiatives for improving the standards of corporate conduct and governance in Russia. The most significant has been the introduction of the Code of Corporate Conduct, developed under the supervision of the Federal Commission of Securities Markets (FCSM) and sponsored by the EBRD and the government of Japan. Earlier efforts included the OECD's series of round table discussions on corporate governance in 2000-2002 and its White Paper on Corporate Governance in Russia. The IFC launched the Corporate Governance Project to assist companies to introduce good governance practices and focus on actions to improve investment attractiveness; the IFC is now developing a corporate governance manual.

The redistribution of ownership stakes, the introduction of strategic shareholders -- often in conjunction with significant investments -- and the desire to attract outside capital are major driving forces in the improvement in governance standards in Russia.

Although the process of ownership consolidation continues with powerful interests competing for control of attractive assets, the positions of controlling shareholders and other strategic investors have become clearer and more stable in the case of many of Russia's major economic entities. Once the struggles for control are finally resolved, improving performance and attracting capital to fund growth will become top priorities. These objectives approach the paradigms by which international markets operate, and they improve Russia's acceptance within those markets.

Market Infrastructure

Economic Situation. Russia's 1998 financial collapse closely followed the Asian financial crisis and a steep fall in international oil prices; the country's subsequent recovery, led by a sharp increase in oil prices and the economic benefits of a three-fold devaluation of the ruble, has been accompanied by increased political stability and significantly improved fiscal management.

Although Russia's recovery has been impressive (real GDP increased by an average of 6.5% in 1999-2001, by 4% in 2002¹, and preliminary figures for January – April 2003 suggest GDP growth over 6%), and prudent economic management has supported fiscal and budgetary stability, analysts are still concerned by the country's dependence on oil and gas exports (over 50% of total exports). A \$1 change in Russia's oil price per barrel has a corresponding \$1 billion effect on Russia's budget. While Russia today would be much better able to withstand a sharp oil price drop than in 1998, a sustained low oil price would pose challenges for the country's budget. Rising oil prices, a budget surplus, and the increasing reserves of the Bank of Russia have helped to resolve a \$17 bn 2003 foreign debt payment spike without IMF aid or new Eurobond issues this year. At the same time the continuing appreciation of the ruble – in particular against a weak US dollar - will have an adverse effect on Russia's international competitiveness. Although gradually reducing by a few percentage points a year in the past few years, inflation is still in the double-digits (during 2001 and 2002, the consumer price index increased by 21.6% and 14.5%, respectively²).

In spite of the country's huge capital needs in order to repair and replace its aging industrial infrastructure, Russia has been unable to attract significant foreign direct investment in the post-Soviet period, with direct investment making up less than 1% of the country's gross domestic product. By contrast FDI accounts for 5-10% of GDP in central and Eastern Europe. According to the Bank of Russia, the country received \$3.3 billion in direct investment in 1999, \$2.7 billion in 2000, \$2.5 billion in 2001, and \$1.8 billion in the first nine months of 2002³. Though it appears that investment has been stagnant, there are some recent positive signs of change. Most notably, in February 2003 British Petroleum announced a plan to invest \$6.75 billion in a joint venture with the Russian oil major, TNK, and a number of consumer and auto sector investments have also been announced this year.

¹ Hessel Helena. "Russian Federation (The). Credit Rating Report". *Standard & Poor's. RatingsDirect*. 02-January-2003.

² Hessel Helena. "Russian Federation (The). Credit Rating Report". *Standard & Poor's. RatingsDirect*. 02-January-2003.

³ "Balance of Payments of the Russian Federation (analytical layout)". CB of the RF. http://www.cbr.ru/statistics/credit_statistics/

While Russia has made significant progress since 2000 in moving ahead with key structural reforms - including tax, land, pension and judicial reforms - momentum has slowed and major issues of bank, administrative, natural monopoly and other reforms remain to be tackled. A notable step forward, on the other hand, occurred when the individual income tax rate dropped to a flat 13% in 2001, and the profit tax was reduced to 24% in 2002. Nevertheless, tax collection, although improving, remains a concern.

The degree of government intrusion into the economy remains high. Tariff regulation in a number of industries (gas, electricity, transportation, and telecommunications) hampers growth and investment. Many industries rely heavily on government support, primarily in the form of cross-subsidies made at the expense of more lucrative and efficient businesses. Examples include fixed-line telecommunications services and local utilities, where certain subscriber categories are subsidized at the expense of others. The airline industry is fettered because some national air carriers are restricted in their ability to purchase more efficient foreign aircraft. As Russia enters an election season, with Duma elections at the end of 2003 and presidential elections in the spring of 2004, substantial progress on reforms is unlikely until the electoral outcome is clear. At the subfederal level, strong regional governments continue to exert their influence over local companies, often interfering in commercial affairs in the attempt to strengthen hidden forms of cross-subsidization.

Another major concern is that, while Russia's credit and payment culture is gradually improving, corruption, excessive red tape, and a chronic lack of transparency in business practices persist as serious problems hampering the growth and expansion of Russia's private sector.

Prevailing forms of ownership and ownership structure. Since 1993 130,000 Russian companies – 66% of the total -- have been privatized, and now account for 77% of Russia's GDP⁴. The government maintains controlling stakes in many key industries, including gas, oil pipeline, telecommunications, electricity, and transportation.

The mass privatisations of 1993-1995 largely determined the models for subsequent corporate ownership and governance in Russia. Seventy-five percent of Russia's enterprises scattered 51% of their shares among employees and managers. As a result, privatisation gave the advantage to insiders, while it failed to bring money to the companies themselves. Intensive buy-out campaigns and questionable loans-for-shares deals made by the government led to the development of powerful financial-industrial groups (FIGs) and holding companies in the oil, metals, coal, chemical, food, automotive, and banking sectors.

Table 1. The concentration of ownership of the 42 largest Russian companies⁵

	Number of companies	Percentage*
Number of companies with large shareholders (more than 30%)	39	86%
Of which, number of majority held companies (more than 50%)	31	60%
Of which, number of companies with big stakes (30%) owned by holdings or part of FIGs	24	42%
Of which, largely owned by the government (more than 30% directly)	9	32%
Companies who are widely held (largest stakes less than 30%)	3	14%

* Share of these companies' market capitalization (MC) in total MC of 42 companies (\$104.14 billion as of 13.08.02).

Today, eight business groups control 85% of the revenue from Russia's 64 biggest private companies.⁶ Standard & Poor's research of the 42 largest publicly owned companies has shown that their ownership structures are highly concentrated and largely non-transparent (see tables 1 and 2). Ownership is often obscured through shell companies registered in Russia or offshore, notwithstanding the legal requirement to disclose owners of stakes larger than 5%. Managers often indirectly own smaller companies.

⁴ *Kommersant Vlast* #45 (447) November 13, 2001

⁵ Standard & Poor's Transparency & Disclosure Survey of 42 Russian Companies. 2002.

⁶ Boone Peter, Rodionov Denis. "Rent Seeking in Russia and the CIS." Brunswick UBS Warburg paper. 2002.

Table 2. The transparency of ownership of the 42 largest Russian companies⁷

	Number of companies	Percentage*
Number of companies disclosing their beneficial majority and largest owners	32	74%
Of which, disclosing the gov-t and gov-t owned holdings	26	48%
Of which, disclosing largest private owners	8	38%
Of which, Disclosing all beneficial owners having substantial stakes	4	34%

* Share of these companies' market capitalization (MC) in total MC of 42 companies (\$104.14 billion as of 13.08.02).

Table 3. Disclosed ownership of the 42 largest Russian companies⁸

	Percentage*
Total disclosed share of ownership of 42 companies, %	40%
Of which, total government and government-owned holdings' ownership, %	16%
Of which, total private ownership disclosed %	24%
Share of disclosed private ownership in total private ownership, %	29%

*Share of disclosed ownership in total MC of 42 companies (\$ 104.14 billion as of 13.08.02).

Financial markets and their infrastructure. Russian companies are undervalued because of sovereign and corporate governance risks. As a result, when compared to foreign markets, the Russian stock market is shallow. Despite a mostly upward trend in 2001 and 2002, the total capitalization of the Russian capital market in March 2003 was only \$127 billion⁹. Daily traded volumes of equities on the major domestic exchanges (MICEX and RTS) and depository receipts on foreign exchanges were approximately \$300 million. Only three companies in Russia (Vimpelcom, MTS and Wimm-Bill-Dann), have Level III ADRs listed on the NYSE; and only two companies (Rostelecom and Tatneft) have Level II ADRs. In February 2003, the weight of Russia in the S&P/IFCI Composite Index was 6.42% (increased from 3.56% in October 2001)¹⁰; weight in the MSCI Emerging Markets Index was 2.54%.

The domestic bond market, having emerged only in 2001, has rapidly grown. Accumulated domestic corporate debt issues doubled in 2002, and exceeded \$3.5 billion by March 2003; 114 companies issued a total of 153 corporate bonds as of March 2003, including non-market issues¹¹.

Domestic institutional investors are almost non-existent, and capital is usually accumulated and invested through banks. Capital outflow, however, is generally declining due to the Russia's improving investment climate.¹²

Both of the two leading Russian exchanges have introduced rigid disclosure requirements for their first-tier listed companies. Since 2002, they require listed companies to disclose their compliance with the provisions of the Russian Code of Corporate Conduct. Given the competition between the two exchanges, however, and the relatively weak domestic portfolio investment potential, most companies lack the necessary motivation for becoming listed or for upgrading their listing.

Non-governmental public organizations have assisted in improving general governance standards. The National Broker-Dealer Association (NAUFOR) established a coordination center for investor protection in 1999 that later developed into the Investor Protection Association (IPA). The IPA has been defending investor interests through lawsuits and board nominations, while also consolidating investor votes. The IPA facilitated the placement of 49 independent directors on the boards

⁷ Standard & Poor's Transparency & Disclosure Survey of 42 Russian Companies. 2002.

⁸ Standard & Poor's Transparency & Disclosure Survey of 42 Russian Companies. 2002.

⁹ «News of the Russian Economy». *RIA Novosti*, 19/03/2003

¹⁰ "Emerging Stock Markets Review. Performance, Valuations and Constituents." Standard & Poor's. February 2003.

¹¹ www.cbonds.ru

¹² www.cbonds.ru

of 55 companies in 2002¹³. The Association maintains an informative web site that publicizes corporate actions and shareholder rights abuses (www.corp-gov.ru). For its part, the decidedly influential Russian Union of Entrepreneurs and Industrialists has established a Supervisory Board on Corporate Governance, whose aim is to promote good governance standards among member companies; and it has also initiated the establishment of the National Council for Corporate Governance, whose first meeting was held on March 25, 2003.

The Association of Independent Directors (IDA) was established in February 2002, and has been actively assisting Russian companies to adopt best independent director practices. The Russian Institute of Directors (RID) is striving to improve the quality of directors through various training programs. Also, the Managers' Association has undertaken substantial research in the areas of management professional standards and corporate social responsibility.

The Legal Environment

New laws are being adopted to guarantee greater accountability and corporate governance; these include The Civil and Arbitration Codes; the Joint Stock Company Law (JSC Law); the Law on Limited Liability Companies; the Law on the Securities Market; the Law on the Protection of the Rights and Legitimate Interests of Investors in the Securities Market; the Law on Banks and Banking Activities; and the Bankruptcy Law. A Franco-German model has been used for reforming the Russian legal system as a whole, but corporate law provisions also have Anglo-Saxon antecedents that were incorporated during the years of privatisation. In some ways, Russian laws can be even more protective of the interests of minority shareholders than laws in other nations: for instance, Russia does not allow limitations on voting rights and anti-takeover defenses, and calls for a separation in the roles of the CEO and chairman.

The major legal provisions with regard to shareholder rights

***Ownership rights**

The law grants pre-emptive rights to shareholders for new share issues in cases of placement via closed subscription (for those who voted against it), and for all shareholders in case of open subscription. Also, the law prescribes that the share register should be kept by an outside, professional registrar in all companies having more than 50 shareholders. This does not suggest, however, that the registrar should be completely independent from an issuer.

*** Voting rights associated with different classes of shares**

One share – one vote for common shares (except for cumulative voting); the law prescribes the voting rights of preferred shares in the most important cases (re-organization, liquidations, amendments to charter, etc.), and in the event that these shareholders do not receive dividends from the previous period.

***The authority of a shareholder meeting and the board of directors**

The range of issues exclusively reserved for the consideration of shareholders and directors is specified in the JSC Law.

***Proper procedures for shareholder meetings**

Companies must announce annual meetings at least 20 days in advance; 30 days in advance if reorganization will be discussed; and 50 days in advance if it will involve the election of a board of directors. Notification must be via registered mail or a mass-media publication. There are also detailed stipulations regarding who can attend, and about registration and voting procedures.

*** The placement of items on agendas**

Shareholders owning (individually or in aggregate) at least 2% of the issued voting shares can introduce proposals for the agenda of the AGM and can nominate candidates for the board of directors.

***Proper voting procedures**

The law requires that large transactions, liquidations, amendments to charters, and changes in numbers of shares authorized for new issues are adopted by a supermajority of 75%. Companies having more than 1000 shareholders must apply cumulative voting for board elections.

¹³ IPA reports. <http://www.corp-gov.ru>

***Proxy rights**

Shareholders may vote in person, in absentia, or by proxy. All votes are given equal rights. Companies with more than 100 shareholders must have voting by ballot. The charter of a company with more than 500,000 shareholders may stipulate the publication of ballots in a printed edition, available to all shareholders.

***The composition of a board of directors (i.e. the number of outside and independent directors required)**

The JSC Law makes stipulations in this area, but ones easy to circumvent. For example, it limits the percentage of members of a management board that can be on a board of directors (no more than 25%), but it does not say how many executives outside of the management board can be on the board.

***The proper procedures for protesting corporate decisions**

Shareholders who vote against a decision or have not taken part in a GSM can challenge a decision in court within six months.

***The proper procedures for share buy-backs**

A shareholder may demand a share buy-back in the event that he either refused or failed to take part in voting on reorganization or other major transactions, supplements, and amendments to the charter that violate his or her rights. In this case, the share valuation is to be made.

***Regulations preventing insider trading**

The Law on the Securities Market stipulates certain types of manager equity interest disclosure, as well as other reporting requirements; however, such regulations are easily skirted through the use of dummy companies.

***Restrictions on the concentration of control**

The Antimonopoly Law requires the Antimonopoly Committee's approval on acquisitions of 20% or more by an individual or single group, or if the face value of acquired securities exceeds 10% of the book value of fixed production assets and the intangible assets of the acquired company. Owners of 20% of a bank's equities must receive authorization from the Bank of Russia. In reality, this measure has little practical use because acquisitions are usually made in the name of different implicitly affiliated companies. The JSC Law stipulates a share buyout offer once a shareholder exceeds a threshold of 30% of ownership interest; however, the specific procedures for this are unclear.

***Disclosure of affiliations and related party transactions, and the specific voting procedures**

A board of directors is to hold a vote, with the interested parties abstaining, once an affiliation between parties of the transaction is identified. For companies with more than 1,000 shareholders, non-interested, "independent" directors, as defined by the JSC Law, take the vote. For large transactions, or in the event that the number of disinterested parties is less than a quorum, matters must be determined via a shareholder meeting.

Legal loopholes and improvements in the legal infrastructure

Company law in Russia has been evolving rapidly during the past several years with further changes anticipated. With both the letter and application of the law in a state of flux, reformers are targeting loopholes, though their success remains to be seen in most cases. This section surveys issues that are being, or need to be, tackled.

There's room for improvement regarding shareholder voting rights and shareholder meetings. Preventing shareholders from participating in meetings is still a popular tool in the corporate war for control. Shareholders can be prevented from participating in meetings through insufficient notification, or excessive registration requirements (the law allows for a disproportionately wide interpretation regarding registration requirements), or even physical hindrances; but the most frequent tactic is the arrest of shares under a court's mandate. Suits have been filed to prevent certain shareholders from participating in shareholder meetings, effectively barring them from participating in decisions on share dilution and other major transactions. In most cases, decisions have been handed down by courts that lack familiarity with equity market issues; and such cases have usually been taken up in the region where the plaintiff resides, sometimes so far away from the company's location that the company can hardly track them. Moreover, the independence and accountability of the courts have been questionable. There is little, if any, legal recourse for offended parties regarding discriminatory

actions by those who did attend the GSM. The new set of procedural (civil and arbitration) codes adopted in the second half of 2002 has, at least on paper, partly resolved this issue: Now, disputes between shareholders (individual and legal entities) and companies are to be resolved in arbitration courts. Claims are to be filed at the location of the company.

Bankruptcy procedures have been another way to abuse shareholders while remaining in full compliance with the law. Easily activated and sometimes false, bankruptcies have been widely used by creditors for purposes of acquiring companies. Through affiliate parties, a potentially solvent company could be stripped of its assets and then brought to bankruptcy – a scheme widely used in corporate wars in aluminum, oil, ferrous metals and other industries for many years. An attempt to tighten bankruptcy procedures was made in the new version of the Bankruptcy Law approved by the State Duma and the Federation Council in July 2002. It sets hurdles for initiating bankruptcy: bankruptcy can now only be initiated if the debt of the company is in excess of a certain material threshold, and 30 days have passed since the company was obliged by a court to fulfill its obligations. It is too early to say, however, whether this law will provide better protection to shareholders.

With no concept of beneficial owners within Russian law, the provision on disclosure of block ownership beyond 5% of voting shares does not work adequately, and there are problems with the proper identification of affiliate parties in transactions. Transactions with possible affiliate parties are entered into without proper disclosure, without truly independent appraisal, without tender, and without proper approval procedures. Assets are sometimes stripped as a result. Also, there is no legal mechanism to disenfranchise shareholders who fail to provide personal information, as there is under U.K. law. This makes laws on affiliate party dealing ineffective.

There is a lack of definition of net income in the Russian law, although the term is mentioned in the context of dividends. As a result, companies can manipulate their financial results under Russian accounting standards to minimize dividend payments, particularly those that have an obligation to maintain a certain payout ratio on preferred shares. The State Duma, however, should soon be adopting amendments to the JSC Law that introduce a definition of net income on the basis of accounting information.

Corporate re-organization is still inadequately covered by the law, which still allows for different accounting and value-setting procedures that may be detrimental to shareholders. The vagueness of existing “fair price” provisions provides inadequate protection. Also, the restructuring of banks in the form of consolidation is hampered by existing requirements on providing options for early debt redemption in the case of restructuring. This pushes banks into confusing ownership structures.

The law allows for discretionary dividend payment periods. As a result, late dividend payments have been commonplace – a particularly frustrating situation for shareholders during periods of double-digit inflation.

A serious issue is that ADR-holders cannot vote directly or through depositary banks on issues other than the election of the board of directors (where the cumulative vote is applied). This is because ADR depositary banks and custodians are regarded as owners, not nominees, and vote splits are only permitted in the case of registered nominee holders. Therefore, ADR blocks must be voted wholly for or against resolutions and not in accordance with their exact vote split; this can obscure the actual voting results. The FCSM has been saying that it will resolve this issue for some time now.

Changing the procedures for share consolidation has been a major step forward. Before recent improvements, the fact that fractional shares were not allowed left minority shareholders in a vulnerable position: holding companies would use swap coefficients to create fractional shares as a tool for forcing minority shareholders of consolidated subsidiaries (whose shares were being swapped for the holding company’s shares) to sell at a loosely defined “fair-price.” In 2002, amendments to the JSC Law made allowances for fractional shares that destroyed these grounds for the forced sale of shares.

Regulatory Environment

Enforcement and accountability. The poor corporate governance record of Russian companies can be attributed in part to the generally weak rule of law, the sluggishness of reforms, and such specific cultural features as a lack of trust in government. As a result, enforcement remains ineffective, encumbering greater progress. The problems, typically, are poor transparency, insufficient experience

and widespread corruption. Despite increased activity on the part of the court system in this area, courts usually still fail in preventing or redressing the mistreatment of shareholders.

Current problems of accountability have historical roots. Many managers, for example, remain unclear as to what is even meant by 'shareholder,' because there was no historical precedent. The employee-oriented privatizations of the early 1990s gave rise to thousands of individual shareholders who did not bring capital investment to their companies. As a result, some managers have not been able to appreciate the connection between shareholders and investors. During the Soviet period, company managers typically reported to a single supervisory entity within the rigid hierarchy that dominated the country's industrial infrastructure. In this kind of framework, company information was confidential.

Today, secrecy has more contemporary foundations. Many managers, for example, now view disclosure requirements, such as the publication of CEO and director salaries, as dangerous to personal welfare. In other cases, with entities that work in areas connected to national security or national strategic reserves (such as Aeroflot and Norilsk Nickel), specific regulations actually *require* confidentiality and preclude better disclosure. Companies in corresponding sectors in many other countries are not similarly subject to secrecy laws.

Securities regulations. The FCSM is a regulatory, coordination, and controlling body. Its main functions are to set rules for brokers, certify specialists in the securities markets, and register securities issues. It penalizes companies for non-compliance by imposing fines for inappropriate disclosures and late filings, by suspending trade in their securities, or by rejecting the registration of new issues. In 2000, it initiated the mandatory registration of the issuance of ADRs by Russian companies; and in 2001, it prohibited company management from automatically counting in its favor votes of ADR holders who had not forwarded proxy voting instructions. There are now stiff penalties for companies that fail to comply with disclosure requirements on time.

The Federal Law on the Securities Market, enforced by the FCSM, regulates registration and depository procedures, and the Professional Association of Registrars, Transfer Agents, and Depositories (PARTAD) monitors licensed professional registrars and depositories. Most large companies now employ independent registrars, and the problems regarding the misuse of share registration procedures have mainly been resolved.

Other governmental bodies also play important roles in enforcement and accountability. For its part, the Bank of Russia regulates the issue of bank securities and provides prudential supervision; it imposes regulations on financial disclosure and the risk management of banks as well. The Ministry of Finance specifies rules for auditing and certifies auditors.

Russian regulators, however, lack the power to investigate ownership structures beyond what is disclosed in regulatory filings (quarterly reports to the regulators mostly contain unhelpful information about nominee owners). This state of affairs, as we have discussed above, results in the continued inadequacy of information disclosure, permitting the stripping of assets and other modes for fleecing shareholders.

Rules and codes. A Code of Corporate Conduct (the Code) was developed in 2002 at the initiative of the Russian government and the FCSM, and sponsored by the EBRD and the Japanese government. The initiative was first presented to a public forum in late 2000; after more than a year of public deliberation and revision, the Code was approved by the Russian government in April 2002 and recommended for voluntary implementation.

The goal of the Code was to fill the gaps in existing corporate laws and to familiarize Russian companies with the best practices of corporate governance and conduct. The Code recommends the wider disclosure of owners beyond nominee holders and the disclosure of affiliate relations and relevant information about directors; it advocates having at least three-quarters of the board filled by non-executive directors and one-quarter by independent directors (minimum three); it gives a definition of independent directors and explains why they are needed.; and it prescribes that directors have free access to all necessary information and recommends the appointment of a corporate secretary to be responsible for providing such information. The Code also stipulates that a number of committees (strategic planning, personnel, remunerations, and settlement of corporate conflicts) are to be established by the boards.

Implementation of the Code has been slow, however. At the prompting of the FCSM, Russia's two major exchanges started promoting corporate governance standards by modifying their listing

standards. Companies included in the top-listing category, first-tier companies, must comply with each provision of the Code, and second-tier companies must provide statements of their degree of compliance. Under the RTS listing rules, first-tier companies are required to present IAS or GAAP financial statements. The relative lack of interest in domestic listings, however, limits the impact by these measures on governance standards. It is not yet clear how compliance with the Code of Corporate Conduct will be implemented.

Information Infrastructure

Financial disclosure standards and requirements. Accounting practices in Russia are considerably behind the best international practices. In accordance with reporting requirements, companies must present the FCSM and tax authorities with quarterly financial statements, including balance sheets, profit and loss statements, cash flow statements, capital statements, an accounting of the use of funds, and notes on the balance sheets. Russian accounting standards differ greatly from IAS and GAAP standards, and, while they serve the purposes of tax authorities and other official bodies, they have little value for investors. One problem is that consolidated statements are not prepared in the Russian system, since tax authorities require only single-company tax returns. Other key differences include: accounting for fixed assets; recognition of liabilities; policies on reserves, and use of estimates. In 2001, the Ministry of Finance adopted a long-term plan for the development of a more compatible accounting system. This three-stage plan will culminate in 2010, and sets out steps to be taken for adopting and implementing an "IAS-compatible accounting system." It stipulates that as early as January 2004, Russian banks and public companies will have IAS-based reporting. This seems optimistic: in the middle of 2002, approximately 25 of Russia's 40 largest companies produced IAS and GAAP statements and reports¹⁴ audited by one of the Big Four firms. Smaller companies are much slower to adapt to the newer practices because of the costs involved.

Progress is also being made in regard to the quality of training of the accountants themselves. The Institute of Professional Accountants has been issuing certificates to professional accountants since 1998. In 2000, the International Federation of Accountants (IFAC) awarded the Russian Auditors Collegium, a professional association of about 800 individual auditors, an associate membership. There are approximately 75 Russian audit companies, though only a small number are considered reputable and meeting acceptable professional standards. As a rule, Russian auditors carry out statutory audits, though these are primarily viewed as tax returns. Tax and consulting services are also offered by these firms. The federal Auditing Committee regulates and certifies local audit companies, but the committee does not publicly disclose information about the number and quality of auditors.

Sources of Information and disclosure practices. Adequate and timely disclosure is slowly becoming a common corporate practice in Russia through the establishment of guidelines, greater market education, and consistent enforcement. Quarterly reports on securities to be filed with the FCSM must conform to specific guidelines in terms of structure and content, including the naming of the largest shareholders; they must also report on a company's governance structure, board composition, board remuneration, equity positions of 5% and more, affiliates, branches, number of employees, key business lines, authorized capital, outstanding shares, the names of the auditors, registrar, depository, and major corporate actions. A company must present the report within 45 days of the closing of the reporting period. Also, public companies are required to inform the FCSM of any major developments and changes within the company's structure, and to disclose information about essential facts in the form of ad-hoc reporting to the FCSM within five days of the change or development.

Information provided to the FCSM, however, is rarely made fully or promptly public. The main informational resource regarding disclosure can be found at <http://disclosure.fcsm.ru/>. Corporate actions are published in the FCSM's special edition, *Vestnik FKTsB*. The FCSM website lists the quarterly reports of around 24,000 open joint stock companies (including quarterly financials under Russian Accounting Standards (RAS), corporate actions reports, and governance structures). The information on the site is updated poorly, however, with lags that can exceed a year. The site for the

¹⁴ Standard & Poor's Transparency & Disclosure Survey of 42 Russian Companies. 2002.

Bank of Russia contains information about banks, included financial statements, though it too is not updated in accordance with the stipulated standards.

One of the weakest areas is ownership disclosure. Public companies must disclose information on shareholders who own more than 5% of share capital, including their names and addresses, and also the names and addresses of the owners of more than 25% in their parent companies. Other corporate issuers must disclose their total number of shareholders and provide more detailed information about those holding more than 20% of the shares. The Bank of Russia requires the same level of disclosure for banks. Nevertheless, as mentioned above, without a concept of beneficiary owners, reports on ownership structures are of little use when trying to understand real control structures. More optimistically, under the Registration Law, which went into effect in June 2002, LLPs must report all changes in their ownership structure and charters to the Tax Ministry. This information can then be made available to any person or company upon request.

The JSC Law requires companies to provide a list of those entitled to attend general shareholder meetings at the request of shareholders having at least 1% of the vote.

Annual reports have not yet become a normal source of disclosure for Russian companies. Only large companies produce annual reports, while the quality of information is uneven. Corporate internet sites have increasingly become a major source of disclosure. In mid-2002, the amount of disclosed information on web sites of the 42 largest companies was 41% of the maximum level of disclosure needed for investors, while statutory filings were responsible for 32%, and annual reports only contained 29% of the needed information⁴⁵.

Media reporting on business is not always independent in Russia: financial groups own a significant portion of the Russian-language electronic and print media, and financial groups and the government own the major television networks.

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Appendix: Corporate Governance Scores

Corporate Governance Score ('CGS') reflects Standard & Poor's assessment of a company's corporate governance practices and policies and the extent to which these serve the interests of the company's financial stakeholders, with an emphasis on shareholders' interests. These governance practices and policies are measured against Standard & Poor's corporate governance scoring methodology, which is based on a synthesis of international codes, governance best practices and guidelines of good governance practice. Companies with the same score have, in the opinion of Standard & Poor's, similar company specific governance processes and practices overall, irrespective of the country of domicile. The scores do not address specific legal, regulatory and market environments, and the extent to which these support or hinder governance at the company level, a factor which may affect the overall assessment of the governance risks associated with an individual company (see below 'Country Factors').

A CGS is articulated on a scale of CGS 1 (lowest) to CGS 10 (highes).
CGS 10 and CGS 9 —a company that, in Standard & Poor's opinion, has very strong corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, few weaknesses in any of the major areas of governance analysis.
CGS 8 and CGS 7 —a company that, in Standard & Poor's opinion, has strong corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, some weaknesses in certain of the major areas of governance analysis.
CGS 6 and CGS 5 —a company that, in Standard & Poor's opinion, has moderate corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, weaknesses in several of the major areas of governance analysis.
CGS 4 and CGS 3 —a company that, in Standard & Poor's opinion, has weak corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, significant weaknesses in a number of the major areas of governance analysis.
CGS 2 and CGS 1 —a company that, in Standard & Poor's opinion, has very weak corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, significant weaknesses in most of the major areas of analysis.

GovernanceWatch

A 'GovernanceWatch' designation may be used to highlight the fact that identifiable governance events and short-term trends have caused a CGS to be placed on review. GovernanceWatch does not mean that a change to the CGS is inevitable. GovernanceWatch is not intended to include all CGSs under review, and changes to the CGS may occur without the CGS having first appeared on GovernanceWatch.

Country Factors

Although Standard & Poor's publishes country governance analyses from time to time, it is important to note that Standard & Poor's does not currently score individual countries. However, consideration of a country's legal, regulatory and market environment is an important element in the overall analysis of the risks associated with the governance practices of an individual company. For example two companies with the same Company Scores, but domiciled in countries with contrasting legal, regulatory and market standards, present different risk profiles should their governance practices deteriorate i.e. in the event of deterioration in a specific company's governance standards, investors and stakeholders are likely to receive better protection in a country with stronger and better enforced laws and regulations. However, in Standard & Poor's opinion, companies with high corporate governance scores have less governance related risk than companies with low scores, irrespective of the country of domicile. For a full explanation of Standard & Poor's criteria for measuring corporate governance standards, please refer to the latest edition of "Corporate Governance—Criteria & Methodology".

Important Note

A CGS is based on current information provided to Standard & Poor's by the company, its officers and any other sources Standard & Poor's considers reliable. A CGS is neither an audit nor a forensic investigation of governance practices. Standard & Poor's may rely on audited information and other information provided by the company for the purpose of the governance analysis. A CGS is neither a credit rating nor a recommendation to purchase, sell or hold any interest in a company, as it does not comment on market price or suitability for a particular investor. Scores may also be changed, suspended or withdrawn as a result of changes in, or unavailability of such information.

Although Standard & Poor's publishes country governance analyses from time to time, it is important to note that Standard & Poor's does not currently score individual countries. However, consideration of a country's legal, regulatory and market environment is an important element in the overall analysis of the risks associated with the governance practices of an individual company. For example two companies with the same Company Scores, but domiciled in countries with contrasting legal, regulatory and market standards, present different risk profiles should their governance practices deteriorate i.e. in the event of deterioration in a specific company's governance standards, investors and stakeholders are likely to receive better protection in a country with stronger and better enforced laws and regulations. However, in Standard & Poor's opinion, companies with high corporate governance scores have less governance related risk than companies with low scores, irrespective of the country of domicile. For a full explanation of Standard & Poor's criteria for measuring corporate governance standards, please refer to the latest edition of "Corporate Governance—Criteria & Methodology".

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