Can Corporate Governance Be A Cure For Russia's Epidemic of Investor Risk Perception?

This chapter deals with some very sensitive issues impacting upon the lives and business fortunes of millions of people – mostly Russians – who are winning or losing because of the negative perceptions held by the global investment community concerning Russia "investor risk" and the evolution of Russian "corporate governance and transparency".

As we look back over the last 24 years we should all acknowledge the massive and tragic dislocation in all of the business, political and social systems in Russia and the CIS between 1989 and 2000. However, as measured by the yardsticks that the world uses (FDI, IPOs, market capitalization, GDP growth rate), Russia showed dramatic improvement from the mid- to late-90s through 2007-08. Since that time, even factoring in and out the impacts of the Great Recession, Russia seems to be suffering to a greater extent than the other BRICS in certain important respects. Today, investor perceptions about Russia risk are very negative. Indeed, Russia risk perception is an "epidemic", and the symptoms of the disease are the decline of Russian IPO activity; the increased Russia risk premium and market capitalization risk discount imposed upon Russian entities by those markets; the anemic, sub-potential inward FDI and increased capital flight; and, a disembodied sense in the capital markets that corporate governance in Russia – while it has improved – has not nearly kept pace with the expectations of the investor community.

Hundreds of thousands of investors and business people who have been involved in the successes in Russia over the past 20 years, should express gratitude for the opportunity and the rewards of participating in this transformational commercial era. As further consideration for that privilege they owe a debt to express honest opinions and, of course, to ***DO*** something about them. There are those, as well, who share this responsibility with us from London and New York (and wherever relevant investors reside) to reduce these risks and to accelerate the evolution and improvement of good corporate governance in Russia. At the moment we have or are not doing particularly well.

No matter what is said in all of the negative or critical articles, Russia is and will remain strategic. Millions of people Russians will have great careers. Fortunes will be made. Russian companies will list in Russia and abroad. Russia's hydrocarbon and extractive industries will continue to be sought after to fuel economies for billions around the world. Whether the global investor community perceives risk or not, Russia is and it will be. During the 1990s, however, as chaotic and sometimes tragic as it was, there was a palpable sense of momentum and possibility in Russia. Everything was "on the table". We all *expected* and *anticipated* change, and everyone was putting forth models for that change. "Communism" had "fallen" and, while this was a tragedy for some, there was a reality that there needed to be a new direction. We did not *need* a "burning platform. Within the 90' chaos and devastation there was opportunity and a pioneering sense that great changes was inevitable. We believed, correctly or incorrectly, that we were "all *in*", and all in it *together*. This *was* our burning platform.

Despite all of the recent attention to Russia risk and corporate governance, there are a number of successful Russian public companies listed on the global markets that are regarded as having good corporate governance and having evaluated and planned to contain systemic risks*: e.g.*: Evraz, MTS, Polymetal, Polyus Gold, Uralkali[1]. In a sense

[1] The author acknowledges the privilege to serve on one of these boards today and to have served on one of the others for over six years. No confidential inside information of these companies is disclosed herein.

they have broken free of the negative perceptions on Russian risk, precisely because they have attempted to address their underlying risks – and because they recognized that corporate governance was one of those few risk factors about which these great Russian entities could actually take their own destiny into their own hands.

The main theses of this chapter, therefore, are: (i) if the investor view of Russian investment is generally negative, so that valuations are lower and the risk premium is higher (the "epidemic"), can enterprises utilize good corporate governance as a competitive value enhancer (the "antidote"); and, (ii) to date has the discourse about corporate governance in Russia been far too esoteric and based on the "pull"[2] of the external capital markets external, rather than supported by a strong internal "push"[3]from processes and institutions internal to Russia? If these theses are true, what can we learn from what other markets have done to "push" corporate governance, and what are some pragmatic steps individual companies can take in Russia?

Several caveats are required at the outset. This chapter makes observations about some public matters that are frequently cited in Russia and around the world. They are not mentioned because of a particularly novel position on them. Rather, they relate directly to the perceptions (and, in the collective "mind" of the capital market, perceptions *are* facts) about existential factors that either build or erode investor confidence – "rule of law", regime stability, and the general reliability and dependability of the "market". No serious consideration of Russia risk or corporate governance can omit these matters.

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[2] *I.e.* that Russian companies are satisfying "external" governance, disclosure, transparency, and related standards (for example the UK Combined Code) primarily because of the "pull" of trying to get at the financial resources available from those external capital markets – the magnetic "pull" of other people's money requires these entities to flex towards the external standards required by the sources of the capital.

[3] *I.e.* that within Russia the types of corporate governance, shareholder activism, professional liability for lawyers and accountants and bankers, and the enactment of those "processes" into a more holistic regulatory "push" is comparatively undeveloped.

The capital markets eat and digest *everything*; the capital markets reflect the true *and the false*; and, the capital markets' judgment is swift interminable and *merciless*. Even financially remote Greeks, Spaniards and Cypriots now understand this.

Second, there are far too many advisors who are espousing views that gloss over or minimize the obvious risks, or who facilitated the entrance of some to the capital markets (because they were not really ready) whose very presence exacerbated the risks for other, worthier Russian enterprises[4]. Third, in some cases it is the exchanges themselves who are failing to require Russia's more rapid achievement of good corporate governance, or failing to get them to recognize and remediate risks. In their focus upon, listing and deal flows, they maintain policies of "comply or explain", and rely upon theories of "shareholder enforcement", that combine to set the bar too low to force substantial progress.[5] The view is expressed that the exchanges (and those who are responsible for enforcing the relevant laws, rules, regulations and standards) are aware of these weaknesses as they apply to emerging markets, and have not demonstrated aggressive enough measures that are calculated to motivate good corporate governance.[6]

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[4] Instead, they should help them understand the true meaning of corporate governance, and convince them to make the earlier investment in proper business operating and measuring systems to support governance. These investments support actual compliance as well as reliable systems. This cannot be accomplished in the few months before a listing. In fact, it generally takes at least two years to transition and transform an entity from the "octopus" style of control-focused Russian founding shareholder(s) into a "governed" entity. *See infra* at p. xx.

[5] *See, e.g.,* S. Arcot, V. Bruno and A.F. Grimaud "Corporate Governance in the UK: Is the Comply-or-Explain Approach Working?" Corporate Governance at LSE Discussion Paper Series No. 001 (2005). The authors say this approach works when registrants choose comply, but there was a statistical presence of *choosing* non-compliance as a long term or permanent choice. Non-compliers were not using the UK LSE approach to "hone" their way into compliance (the underlying rationale for the approach), but choosing whether to ever comply or not. Where registrants did not comply, the explanations (the UK's way to give shareholders notice of non-compliance) were often not meaningful or accurate – and the shareholders were not "enforcing" compliance or redress for non-compliance.

[6] *See, e.g.,* "New Money Put The City's Reputation at Risk", The Financial Times (18 May 2013); "Backlash To Hit Scandal-Tainted City", The Financial Times (20 May 2013); "Corporate Governance -- Listing Badly: Kazakh and Indonesian Miners Battling Shareholders in London" The Economist (27 April 2013) p. 63: "Whom to blame? Investors should have paused before piling in. And the London Stock Exchange should have paused before making its standards more flexible. Desperate to attract business away from rival exchanges, it waived a rule for ENRC requiring a 25% free float for listed firms…. Such shenanigans tarnish London's reputation."; "ENRC Looks to Dig Itself Out of a Hole" The Financial Times (4 May 2013) at p.12: "The head of equities at a UK investment institution says: 'ENRC's listing was a farce. We need tougher listing rules. It undermines the City. It is strange when corporate governance is seen as a major issue, companies like this are allowed to list."; "ENRC Faced 11th-hour Hitch over Listing" The

As reported by The Financial Times on 20 May 2013: "The British establishment is to make radical reforms to the listing rules on the stock exchange and push to grill executives of two scandal-tainted emerging market mining companies as it moves to repair the damage done to the reputation of the City by their controversial flotations. "The backlash, to begin next week, reflects investor concerns that a permissive regime has besmirched the standing of London as a financial centre. The hottest recent controversy concerns Eurasian Natural Resources Corp, the globe-spanning FTSE 100 miner facing a criminal investigation by the Serious Fraud Office.

1. What is "good corporate governance"? Whose definition?

There is academic debate (and much commentary at conferences and roundtables) about whether one system of corporate law or governance (usually Anglo-Saxon versus "the world") should be "imposed" on the rest of the world (which in much of the research really means the "emerging markets")[7], or, for example, whether common law or civil law systems have had more of a positive impact upon shareholder protection measures[8]. Sometimes this argument takes place around recitations that there is a Bernie Madoff, that the "housing bubble" and related complex derivatives were an American disease, or

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Financial Times (30 April 2013) at p. X: "An adviser involved with ENRC at the time of the listing said the problems with Russian trading were considered by UK Listing Authority while vetting the oligarchs … as directors of the company…. 'They [the UKLA] saw a lot of red flags…"; "SFO Launches Criminal Probe into ENRC" The Financial Times (25 April 2013) at p. X: "ENRC has been the subject of long-running corporate governance concerns, which have fueled a debate over whether the UK should have tougher listing requirements."

[7] *See, e.g.,* "Does English and American-Style Corporate Governance Translate to Emerging Markets", IFC Corporate Governance Forum, Interview with Dr. Prabirjit Sarkar, where Dr. Sarkar posits that such common law based models are not impose-able, and the "uniqueness of individual country contexts" should be respected.

[8] *See, e.g.,* Armour, Deakin, Sarkar, Siems and Singh: "Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis", University of Cambridge, CBR Working Paper No. 108/2008 (2008). *See also,* A. Klishas: "Western Standards of Corporate Realities and Russian Realities", National Corporate Governance Report, Vol. IV, p. 21 (2011).

that Rockefeller and American robber barons[9] were not any different 120 years ago than those who are criticized in Russia today (so why should Russia or any emerging model aspire to these such standards?). There is a related argument, as well, that, in times of crisis corporate governance is lower on the priority list, and resources are better directed on enhancing operational cash flows (and therefore not upon the relative corporate "window-dressing"). [10]

There will always be the *next* market crisis and recessions – even "great" recessions. There will be great criminal cases and systemic failures. Within these ups and downs of the economic cycle, the capital markets will react much like an evolving organism, gathering intelligence and making decisions (rational and irrational), and learning. [11] Corporate governance alone will never be the ultimate factor that creates or prevents systemic market upheavals. Good corporate governance, however, *can* be a factor in any one enterprise's behaviors that makes matters worse or better (for that enterprise) than the ups and downs of the greater the market. Whether a group of critics questions a particular

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[9] *See* Gale Encyclopedia of US History: Robber Barons: "At the turn of the twentieth century, crusading journalists and other critics scornfully labeled the leading business titans of the age, the 'Robber Barons.' … Disgust with the power of corporate America and individuals like … Carnegie, ... Rockefeller, and J. P. Morgan led to the growth of the Progressive Movement and to reform efforts, including antitrust legislation, and investigative journalism, or muckraking." During the Great Depression in the US, in response to the behaviors that contributed to the 1929 stock market crash, passed the 1933 Securities Act, and the 1934 Securities Exchange Act (the latter gave birth to public and private litigants' 10b-5 actions for securities fraud). This legislation was recently described as "The SEC Miracle Drug" that changed positively the landscape of governance and transparency in the US. K. James, "Corporate Governance 1926 -2010: The SEC Miracle Drug and the Evolution of Resistance", London School of Economics Financial Markets Group (20 February 2012) (hereinafter cited as "James, SEC Miracle Drug"). The US' and UK's use of financial scandals to advance governance and transparency in systemic (if imperfect) ways is described in section 3, *infra*.

[10] *See* I. Radionov: "Ways of Improving Corporate Governance in Russian Companies", National Corporate Governance Report, Vol. IV, p.35, at pp. 36-37 (2011). *Cf,* Y. Danilov, Y. Simachev and A. Yakovlev, "Topic of the Year: Implications of Economic Crisis for Corporate Governance in Russian Companies", National Corporate Governance Report, Vol. III, p.12 (2010).

[11] The author agrees with many of the observations in "James, SEC Miracle Drug", *supra, n.* 10, particularly, that after crises and "new" legislation to correct misbehaviors, the market acts like a living organism (bacteria) and evolves new ways to "game a system", and that this tendency calls out for continuing adaptation to strengthen corporate governance, transparency and integrity. It is observed, however, that James' presentation omits reference to the first critical 75 years of evolution of governance and corporate law in the UK and the US which "common law" is subsumed in the US Securities laws – and that James oversimplifies the context of all cycles and the various legislation since the 1960's. The US is indeed not a perfect governance environment. Nor is the UK. While the author herein criticizes some of the aspects of the standards from those regimes, he expresses the firm belief that they are still examples for where the emerging markets need to be headed.

"brand" of corporate governance, or posits that corporate governance may *not* actually eliminate disasters on a grand scale, or may even occasionally fail grandly, is a *non sequitur* as to whether the capital markets will still inevitably demand good corporate governance (and simultaneously allocate a greater share of their investment wallets to those country systems that tend to mitigate the inherent risk factors that give rise to investor mark downs and risk premiums). The critics may be even correct about drawbacks of the governance regimes of the more mature economies with the largest capital markets, but the capital markets will ultimately demand corporate governance and continue to write down values in the absence of these demands being met.

The pragmatic "golden rule"[12] states that he who has the gold makes the rules. Under this "golden" rule, the mature markets demand that a good corporate governance framework "should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities."[13] And, the exchanges that are domiciled in the Anglo-Saxon countries are still, by orders of magnitude (by number of registrants and by the capitalization of those markets), dwarfing all of the other markets.[14] When the number of registrants and the market capitalizations of other the "developed" markets are also considered (*e.g.,* Paris, Frankfurt, etc.), it is absolutely clear why the "western" view of corporate governance, transparency, and shareholders' rights (and, therefore, how they

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[12] The Bible Exposition Commentary: The Complete Old Testament, p. 1453 W. Wiersbe (2007).

[13] OECD Principles of Corporate Governance, p. 17. OECD (2004) (*hereinafter cited as "OECD"*). For the purposes of this chapter, it is assumed that the principles expressed by the OECD, as set forth in its 2004 publication reflect a fair bridge between the civil and common law approaches which should be applicable to both the emerging and the mature economies.

[14] Total market capitalization at 31 December 2012 (US$ Millions) / number of registrants at 2012: NYSE Euronext (NY) 14,085,994 / 2339; NASDAQ 4,582,389 / 2577; London SE 3,396,504 / 2767; Toronto MX 2,058,838 / 3970; Australian 1,386,874 / 2056. But, query whether Hong Kong's exchange (or even Singapore's) should be considered Anglo Saxon or some other classification given its foundation and maturation under the laws and business culture as a UK colony.

measure investor risk) is currently so dominant. While the sensibilities and "contexts" of the emerging markets are always worthy of consideration – and there is indeed always room for improvement and innovative approaches – until these hard realities evolve (of where the preponderant volume of capital "resides"), and the exchanges in the emerging markets ultimately dominate, these "western" themes are unlikely to dramatically change. It also bears observing that the investor participation in the exchanges on the "emerged" markets such as New York, London, Paris and Frankfurt are by no means domestic to the domiciles of those exchanges. The investor community in both New York and London is inclusive of dollars and petro-dollars. The behavior of those "markets", and those "markets'" view of "risk" and "governance" are not purely or simply "American" or "British". It would be specious to ignore that this very perception in the minds of the investors – who have a choice about through which capital market platform to invest their dollars and petro-dollars -- about the "personality" and mindset *OF* the market (including the overall market mindset in New York or London, for example, versus Kenya or Venezuela) -- is a driving factor for why they choose to invest in the securities being traded in New York or London, rather than Kenya or Venezuela (or Moscow or Shanghai) in the first place. Moreover, companies from outside the domicile of these major exchanges are far more likely to seek to avail themselves of registration on those markets than any of the others in the world. For comparison's sake, at March 2013, there were 286 companies listed on the MICEX, of which a total of 1 was a foreign company. Where have the emerging markets companies actually been going to obtain capital for their IPOs?

Cross Border IPO Activity of Emerging Markets Registrants 2002 – 20011				
TO □	London	New York	Hong Kong	Singapore
Total for 10 years	480	264	19	183
China	34	134	*	130
Russia/CIS/CEE	93	5	3	-
EMEA/India	132	44	3	5
Latin America	13	27	-	-
USA	62	*	1	-

In the five years ended 31 December 2012, there were a total of 24 Russian cross-border IPOs to the top ten global exchanges: 2 to the NASDAQ; 18 to London; 2 to Hong Kong and one to Frankfurt. In 2010 there were 5; in 2011 there were 9; and, in 2012 a total of 4. To put this in perspective, during this five year period, when there were 458 cross border IPOs in New York, London and Hong Kong (out of a total of 1766 IPOs in those three markets), 22 of those were from Russia.

The inescapable conclusion from the data and the history is that the OECD is correct: investors want an efficient and transparent market and corporate governance is believed to be a contributor to that result. What then should our working definition of "corporate governance" be? All modern definitions begin with Berle and Means,[15] and Berle and Means pronounced in one pithy sentence the foundational notion for why we need corporate governance. Because corporations have become such giants with such "tremendous force which can harm or benefit a multitude of individuals, affect whole districts, shift the currents of trade, bring ruin to one community and prosperity to another. [Corporations] have passed far beyond the realm of private enterprise – they have become more nearly social institutions."[16] So, at the core, governance is supposed to be a reliable compass of self-control. Wikipedia's definition is:

"Corporate governance involves regulatory and market mechanisms, and the roles and relationships between a company's management, its board, its shareholders and other stakeholders, and the goals for which the corporation is governed. Lately, corporate governance has been comprehensively defined as 'a system of law and sound approaches by which corporations are directed and controlled focusing on the internal and external corporate structures with the intention of monitoring the actions of management and directors and thereby mitigating agency risks which may stem from the misdeeds of corporate officers.'"[17]

Many Russian controlling and non-controlling shareholders, executives, and even some of their advisors pay significant lip service to the "concept" of corporate governance, but then seem to underestimate the importance that the investor community places upon it. To gain a better appreciation they should participate in deal and non-deal roadshows and sit in front of the funds' analysts and investment managers and field their questions. Or,

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[15] The Modern Corporation and Private Property, A. Berle and G. Means (1932)
[16] *id.* at p. 46.
[17] Citing, OECD, *supra* n. 15; A. Tricker , "Essentials for Board Directors", Bloomberg Press (2009); and, A. Sifuna "Disclose or Abstain: The Prohibition of Insider Trading on Trial", Journal of International Banking Law and Regulation 12 (2012).

read the financial press in London or New York (for example a Nexus or Lexis search on "ENRC and governance"[18]). Unfortunately, most of those who are interested in listing their companies often only get to participate in these sobering dialogues after they have already begun the process for listing their companies (and after which time, working with their teams and their advisors, they had presumably enacted real corporate governance practices and structures that they have described as already effective in their various presentations and prospectuses).

When and if they do sit through these meetings they will experience that, among the top two questions asked (by frequency and by how soon it comes in the dialogue), is the subject of the effectiveness of corporate governance in their company. When they are asked these questions, what will they respond? Will they say that everything works well and that they have appointed real independent and non-executive directors who have been working with the owners and the management to put in real controls and reliable reporting mechanisms and the board has real power and influence? Will they say that they began these efforts long enough ahead of the listing process so that real corporate governance, transparency and integrity are alive and evolving in the company? Will they be telling the truth? Will those who write the prospectus be exaggerating about the progress in these dimensions? When the representatives of the equity buy side are in the meetings, will they believe the company representatives? Is there a credibility gap that is widening between what the "road-showers" say and what the investor community believes to be the fact?

[18] See, e.g., The Financial Times, 27 April 2013, p. (requests for UK authorities to investigate irregularities in ENRC including improper corporate governance).

The point here is not necessarily that corporate governance is important and that it can create value. It is and it does. The point is that, in 2013 -- at the same time that serious dialogues occur about Moscow as a top global financial center, or that its replacing Cyprus as a great “offshore banking and corporate center”, or bemoaning the narrowing spigot (instead of the what used to be called the “pipeline”) of Russian IPOs -- the people “out there” doing the capital markets investing are messaging in so many different ways that they are not sanguine with the state of Russian corporate governance, or the underlying state of Russia risk.

2. Risk Epidemic?

In a survey in January 2010 by the Royal Bank of Scotland about the main risks cited by institutional investors faced by Russian companies, they cited “dependence upon oil price” (77%), poor level of corporate governance (69%), and risk of government intervention (51%). In a survey conducted between February and March 2010 by BNY Mellon of top emerging market asset managers about the key factors affecting decisions to invest in BRIC IPOs, they cited: the quality of management (67%), corporate governance (39%), the quality of the business model (22%), the underlying market dynamics (22%), competition (17%), and transparency (17%). So, sophisticated emerging markets investors said corporate governance was roughly twice as important as the business model (in terms of areas of risk concern), and underlying market dynamics and transparency were roughly in the same level of importance as the quality of the business model. Corruption is cited as a perennial factor that undermines Russian access to capital markets.[19]

A profile of what the average capital markets investor is looking for, in terms of the evolution of an emerging market, to make a decision the factors would include:

- "Rule of Law" – has the market evolved so that the investor believes that it is capable of understanding the "rules of the game", is there an "even playing field", is there a reasonable forum for the mediation of disputes which is not so arbitrary or draconian as to be akin to a game of chance rather than a system of laws, if things go bad (as from time-to-time they do) can investors rely on a fair shake? Are minority shareholders treated "fairly"? Do controlling shareholders have limits to their ability to act as though they are "sole owners"?

- Are business decisions conditioned on corruption – is the winning or keeping of business contingent upon bribes, is the maintenance of licenses or the gaining of normal approvals based upon payments to officials, is the practice of corruption epidemic or isolated, are the business models anchored in corruption, does the type of corruption create inefficiency and unpredictability, is the risk of disclosure of illegal practices significant?

- Where is the market headed in terms of the general business climate and its evolution as a reliable destination for major investment – is it a magnet for capital or a place from which capital flees, is the native population embarked upon an improvement

[19] *See, e.g.,* Der Spiegel "Promising but Perilous: German Firms Put Off by Russian Corruption" (03 April 2013); BBC News "Russia's Growth Stifled by Corruption" (28 June, 2012); The Source (Blogs, The Wall Street Journal) "Corrupt and Inefficient: What BP Really Thinks of Russia" (14 February 2013); Beyond BRICS (Blogs, The Financial Times) "Davos 2013: WEF Report Urges Russia to Tackle Corruption and Step Up Reform" (23 January 2013) (quoting S. Mergenthaler and A. Bishop "Russia: A Great Run But An Uncertain Future" World Economic Forum Strategic Foresight Practice, The Scenarios for the Russian Federation (2013)). *See also,* US State Department "2012 Investment Climate Statement – Russia" at pp 7-9.

of the infrastructure and the country's institutions so that it is creating a sustainable cadre of businesses (or conversely, are its labor costs so attractive or its work force so talented that that they make up for the decaying infrastructure and capital flight)?

- Is the economy a "one trick pony" (so that it may be captive to a particular facet of the cycle) or is it on a path to some sort of diversification so that a variety of corporate models could be expected to develop?
- Is the government institution itself self-sustaining and stable, or is there a presumed "shelf life" or periods of volatility?

Once these factors are weighed by the investor, a series of questions may be asked about the particular investment target, as set forth at the beginning of this section (the quality of the particular business model in the particular industry, the quality of management, the financial status of the investee (history, capital structure, liquidity, projections), etc.). At some point, as well, the investor must consider the investment target's corporate governance, transparency, and perceived integrity.

By no means is this either a zero sum game or a "blanket" in/out decision. The global emerging markets funds, for example, are in the business of investing in these very markets and in the business of taking higher risks. Some of their resources must go to virtually every emerging market, and some investors have a higher risk appetite. For them higher risk means high reward. And, even in the riskiest markets there will be individual enterprises that are viewed, compared to their country peers to be a better risk.

What does the average investor (which can equally be read as "creditor", "joint venture", "buyer", "licensor", etc.) see *today* in Russia, when he is considering an investment ("loan", "bond purchase", "venture/ partnership", "purchase", "license", etc.), after a reasonable degree of research currently on the various factors that drive the "investment" decision?[20]

Rule of law. As stated at the outset, the investment community is reading and following all the headline-grabbing events of the day in Russia. Some of them (*e.g.*, the Magnitsky affair and Horizon Capital; the Foreign Agent/ NGO law and the ongoing searches of NGO's Russia premises; the TNK-BP / Rosneft saga; reportage that Russia's 20 biggest billionaires use offshore vehicles and keep their fortunes beyond the jurisdiction of Russia[21]; frequent articles about the lack of independence of the judiciary and the use of "trumped up" charges (including the involvement of the tax police, the popular coverage of the "maski" game where black balaclava-wearing SWAT police invade corporate offices to supposedly carry out "pre-trial discovery") to resolve "commercial disputes" (on the one hand, where some others who are reported widely to have committed corrupt acts are not prosecuted)) – all of these have a drip-drip effect upon the capital markets' perception of the state of the rule of law in Russia.

Moreover, these are not matters of ancient history. The saga of BP, its attempted transaction in Russia that appeared to have national leadership support, its litigation with its TNK partners, its sale of its stake in TNK-BP, and the more recent concerns of the former TNK-BP minority investors as to their future treatment by Rosneft -- all of this has been playing out again over the last several months -- and at the end of March the

[20] As set forth at the outset of this article, it is not necessary that the reader here, or the average Russian business founder or regulator agree with the underlying "truth" or "merit" of the "findings" described in this section. They are what they are. But the "market" digests all of these "findings" and makes a case-by-case investment decision. Or, in the case of some funds or ventures, a systemic view about Russian risk.

[21] See e.g., R. LaFranco and A. Sazonov, "Russia's 20 Biggest Billionaires Keep Riches From Putin", Bloomberg News (1 May 2013).

price of TNK-BP's shares fell by 40%.[22] The CEO of Rosneft appeared to reach out to the minorities in late April. [23] The Surgutneftegz matter is more recent still. Surgutneftegaz issued financial results to its investors for the first time in eleven years, under newly-enacted Russian law. The financial report disclosed that $15 billion in treasury shares had disappeared from the books of the company. This is the equivalent to 40% of the value of the company. There was no explanation in the accounts, and the company did not answer the questions from the analyst community about them. Otkritie Capital said this "will have grave consequences for the investor perception of Russia's investment climate."[24]

To solve this problem is beyond the control of any particular issuer or enterprise in Russia. The real issue, therefore, is what should Russian enterprises do about the implications of "rule of law" risks upon their own access to the capital markets?

Corruption. There has long been a debate as to whether corruption inhibits inward foreign direct investment.[25] The World Bank, however, authoritatively states that it does[26] While there may be some uncertainty about how deeply corruption may adversely impact inward FDI, it constantly is cited by investors as a negative factor in their investing in or holding equities in enterprises where there are disclosures about corruption. One merely

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[22] "Oil in Russia – Picnic Time for Teddy Bears", The Economist (6 April 2013): "Stiffling minority shareholders now could make it harder for Rosneft to tap foreign capital markets in the future."

[23] "Rosneft's Sechin Says to Work with TNK-BP Minority Shareholders", Reuters UK Edition (23 April 2013). See also, "Sechin Tells TNK-BP Investors Rosneft Is No 'Charity Fund'"", Reuters Int'l Edition (23 April 2013).

[24] "Surgutneftegaz Results Show $15 Billion Missing Treasury Shares", Fox Business News (1 May 2013); "Surgutneftegaz Reveals $15 Billion of Treasury Shares Missing from Books", The Financial Times (30 April 2013); "$15 Billion Worth of Surgutneftegaz Shares Go Missing", Business News Europe (2 May 2013). Otkritie also said: "This misappropriation exceeds the losses for both the Enron and WorldCom cases." Interfax Energy (2 May 2013).

[25] *Compare:* Shang-Lin Wei "How Taxing Is Corruption in International Investments?" National Bureau of Economic Research Working Paper 6030 (1997) at p. 24: "[a]n increase in the corruption level in the host governments would reduce inward foreign direct investment…" *with:* A. Al-Sadig "The Effects of Corruption On FDI Inflows" Cato Journal, Vol. 29, No. 2 (Spring/Summer 2009) at p. 268: "Our results show that the corruption level in the host country has an adverse effect on FDI inflows: a one-point increase in the corruption level leads to a reduction in per capita FDI inflows by about 11%" (however, the negative impacts of corruption on inward FDI could be more than offset by robust development of "institutions" and rule of law).

[26] The World Bank Group "Corruption, Growth, and Investment" (http://go.worldbank.org).

needs to consult the stock prices of those institutions that are actively dealing with official allegations of corruption (they go down), or the ability of companies which announce they want to IPO, but then reveal some corruption scandal, to have accomplished their listing thereafter.

The "good news" is that in Transparency International's Corruption Perceptions Index, Russia moved up from 154 out of 178 in 2010 to 133 out of 178 in 2012. Correlating the corruption issue with "ease of doing business" helps to fine tune the concern. The World Economic Forum's Global Competitiveness Report consistently rates the most restrictive problem factor for doing business in Russia as corruption (as it does for India and China), however, when other factors are considered in the overall competitiveness rating, Russia falls to last place among the BRICS (67th in 2013, compared to China 29th, Brazil 48th, South Africa 52nd, and India 59th – for comparison, the US 7th, UK 8th, Hong Kong 9th, Kazakhstan 51st, and Cyprus 58th). Among the other factors that weigh Russia down is "institutions (*viz* "rule of law"). As Mergenthaller and Bishop[27] observed on the WEF's view of Russia's "uncertain future": "corruption has gone unabated in [Russia] despite a significant increase in GDP, while growing spending on an ever-larger government apparatus has failed to improve the delivery of public services in sectors ranging from health to infrastructure."

Corruption is a worldwide, not just a Russian problem – so why does Russian corruption have such a chilling impact on the capital market aspirations of Russian entities? There is, of course, the bromide of the World Bank, WEF and OECD and other global "good order" organizations that believe that corruption is wasteful and immoral. The Russian corruption problem, however, has several sharp edges that have wounded registrants in

[27] *supra,* note 21.

the US and the UK. Daimler and Siemens and others have faced serious US Foreign Corrupt Practices Act penalties related to business in Russia.

Recently, the UK has enacted strengthened anti-bribery legislation called the Bribery Act. The efforts of the UK Serious Frauds Office in investigating corruption in ENRC, cited *supra*, are being conducted under the Bribery Act. Over the past two years, the media attention in the UK, and the attention of the legal and accounting community, upon the Bribery Act, how it will criminalize bribery, its extraterritorial application to UK citizens who bribe, and its application to foreign issuers of shares and GDRs, have all been massive. For years, the UK financial press had been full of tales of the application of the US' FCPA and its sword of Damocles potential to the heads of US registrants. The Bribery Act simply brought the US' FCPA history home to the UK and all of its own citizens and companies – and by extension to some extent, to those Russian companies that have availed themselves of the UK markets. It is therefore not an overstatement to observe that the investment communities in the US and the UK – and by degrees, wherever US and UK funds and law firms and accountants are invested/reside – have a special sensitivity to bribery and corruption. In this sense, the pronouncements of the WEF, the World Bank, OECD, Transparency International, the Russian Levada Center, etc., are evidence of the growing power of the anti-corruption mindset in the developed world. This is not a value statement or an evaluation of values. It is simply a fact.

As was stated with respect to "rule of law" concerns, there is little that any one Russian enterprise can do to eliminate the markets' concerns about Russia corruption risk. However, there are steps that any Russian enterprise can take to turn these concerns into a competitive advantage vis-à-vis all other Russian entities who are competing for the same capital markets investment dollars.

Capital flight. In February 2013, Alexander Bastrykin, the head of Russia's Investigative Committee, announced that Russia needs to create a specialized financial police to combat illegal capital flight.[28] Bastrykin's observation came one day after Russia Central Bank leader Sergei Ignatyev said that in 2012 $49[29] billion was illegally transferred out of Russia. Since 2008, somewhere near $350 billion has fled Russia (2008: $134 billon; 2009: $56 billion; 2010: $34 billion; and, 2011: $80 billion). Observers estimate that capital flight for 2013 should be around $50 billion. A study by Ernst & Young, however, reported that when accounting quirks, offshore M&A deals, and errors and omissions are taken into account, much of the capital flight is not really illegal.[30] Perhaps Ernst & Young is referring in part to the fact that some Russian wealth creators utilize offshore holding company vehicles to own their assets in an effort to move the control to a jurisdiction that eliminates some of the rule of law concerns cited above.[31]

Why is the capital flight tied so closely to the investor perception of Russia risk? This became very clear to the worldwide community in connection with the Cyprus banking crisis and bailout. One reporter described the situation as follows:

"Around 40 percent of Cyprus bank deposits [totaling $88 billion] belong to Russian individuals or businesses... Why are a quarter of the deposits in Cyprus's banks from Russia? The answer is twofold. First, Cyprus's economic strategy involved making the island a tax haven for investors through low tax rates, an Anglo-Saxon legal system,

[28] "Russia Needs Financial Police to Combat Illegal Capital Flight", Reuters US Edition (21 February 2013).
[29] In March, however, there were reports from the Central Bank that the amount for 2012 was $57 million.
[30] "Experts Shed Light on Russia's capital Flight", Russia Beyond the Headlines (11 March 2013).
[31] *See* n. 29, *supra*, "Russia's 20 Biggest Billionaires Keep Riches From Putin.

and affordable real estate. Many Russians took full advantage of this status, engaging in a game of 'round-tripping' -- sending money from Russian accounts to Cypriot accounts, and then back to Russian ones. As a result, Cyprus is the biggest foreign direct investor in Russia… Second, economic freedom is low in Russia. According to The Heritage Foundation's *2013 Index of Economic Freedom*, Russia ranks near the bottom in economic freedom indicators, partly thanks to a dysfunctional legal system, poor property rights, expansive organized crime, and government corruption. This lack of economic freedom means that Russians aren't interested in keeping their money at home because investment and political risk is high."[32]

These then were the very people who had actually made the most from the Russian system, and yet were the very ones who were creating major hedges against that system. It is fair to say that the global capital markets' investors' view of Russia risk is based upon these factors.

Foreign Direct Investment. In 2007, many observers were predicting that "the combined economies of Brazil, Russia, India, and China ("BRICs") appear likely to become the largest global economic group by the middle of this century".[33] Recent publications demonstrate that the BRICs "have emerged as major recipients of FDI and important outward investors."[34] As to FDI inflows, the BRICs rose from 6% of the global share in 2000 to 20% (totaling $263 billion) in 2012. But the picture is very uneven.

Over the past ten years the US remains the largest single country recipient of FDI, averaging over $118 billion per year (and averaging over $182 billion per year over the

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[32] "Cyprus Bank Bailout: Russia Partly to Blame", The Foundry (Heritage Network) (28 March 2013).

[33] Y. Duan, "FDI in BRICs: A Sector Level Analysis", International Journal of Business and Management, Vol. 5, No. 1 (2010), quoting Cheng, Gutierrez, Mahajan, Shachmurove, and Shahrokhi, A Future Global Economy Built By BRICs", Global Financial Journal, Vol. 18, No. 2 (2007).

[34] UNCTAD, "Global Investment Trends Monitor" p. 1 (25 March 2013).

last 5 years). Western Europe as a “group” of countries averaged the highest ten year period amount ($132 billion), but over the past five years was $40 billion per year behind the US (at $143 billion). The “Rest of Europe” as a “group” averaged $121.5 billion over ten years, and 124.7 billion over the last five years. The highest FDI year among the last ten years for all three was 2008 (as it was for almost every country or group that is among the top 25 global inward FDI targets in the world – the exceptions being China, whose best year was in 2003 at $140 billion, and Brazil, whose best year was 2011 at $63 billion). When we analyze the ten and five year inward FDI trends for the BIRCs, they are interesting (US$ billions):

Country	10 YR Ave	5 YR Ave	Highest YR	YR
China	112	104	140	‘03
India	47	54	81	‘08
Brazil	35	44	63	‘11
Russia	34	33	60	‘08
So. Africa	7	9	14	‘08

As with investors in the capital markets for equity, all countries are competing for wallet share of available FDI resources. There are countless reports and media observations that are consistent with UNCTAD’s conclusion. Russia is simply not winning the battle among the BRICs for potential share of inward FDI. The observers indeed write reams of analyses for why Russia is not winning the FDI battle, and why it is not winning among the BRICs. Generally, these analyses track exactly the contents of this section of this article (corruption, rule of law, capital flight, lack of infrastructure investment, red tape, poor demographic outlook, etc.). Investors are using FDI measures as one of their surrogates for scoring market risk and attractiveness.

Market dynamics. There are three aspects of a market that are frequently the focus of investor attention: demographics, infrastructure, and “red tape”. Demographics say an enormous amount about a country’s labor force, its dynamism, and its social net. Some sociologists and statisticians claim it is the key determinant of a culture’s power upswings or downswings (*e.g.*, India’s massive cohort of working age people versus “old” Europe’s birth dearth and focus on social welfare; China’s current growth power but looming demographic crisis, labor shortages, and lack of a social net; America’s immediate financial challenges but continual renewal and transformation through its growing Hispanic and immigrant populations), because it is a leading indicator about a society’s intrinsic views and energies. “Infrastructure” is viewed as a factor in cost of entry and cost of operations, as well as a country’s and a people’s own commitment to the repair and revitalization of the means of their own ability to do business, live, and care for their society. “Red tape” is perceived as a leading indicator of the speed to production and speed to market and innovation in a society. Are we more worried about “Jobsworth-ian” form-filling and value-destroying bureaucracy, or about building jobs and entrepreneurship? Do we need to bribe the local government municipality to get power (IKEA)? And if so, is it really worth it to open a store here when we could more easily open 130 in Brazil (Walmart)? For purposes of Russia, a fourth factor is considered here: the degree of commitment to a single industry to support the GDP, and whether it is a perceived concentration risk.

An interesting footnote appears in Vimpelcom's 20-F Report filed on an annual basis with the SEC in Washington: "Russia's physical infrastructure is in very poor condition and further deterioration in the physical infrastructure could have a material adverse effect on our business. Russia's physical infrastructure largely dates back to Soviet times and has not been adequately funded and maintained in recent years. Particularly affected are the rail and road networks, power generation and transmission, communications systems and building stock… The deterioration of Russia's physical infrastructure harms the national economy, disrupts the transportation of goods and supplies, adds costs to doing business in Russia and can interrupt business operations…" Similar notes and caveats can be found in other filings by other companies in their annual reports, financial statements, prospectuses and offering circulars.

There are many reports that cite Russia's difficulty with red tape bureaucracy.[35] The World Bank's annual Doing Business Survey traditionally marks Russia down in ease of doing business. As one article about Russia's red tape observed about the World Bank survey, "despite the Duma passing new laws at a record-breaking pace, Russia's score failed to improve in every category [from 2010 to 2011]"[36]—and observed that Russia' aggregate ranking fell more than any other country's from 116th place to 123rd place (while neighboring Kazakhstan's had jumped 16 spots). "[I]f a country has onerous, vague and contradictory regulations on business activity, there will likely be less business activity.[37]"

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[35] "Red Tape, Corruption Stall Russian Biz Boom"' US-Russia Business Council (25 February 2013); "The Hell of Russian Bureaucracy", The Guardian (23 April 2012); "The Red Tape of Russian Visas", BBC Travel (13 May 2011); "Long After USSR's Collapse, Red Tape Distorts Russian Economy", Financial Times Blogs: Beyond-BRICs (30 June 2010).

[36] "What's Wrong with Russia – Part II – Red Tape", The Russia Monitor: A Blog on Russian Law, Politics and Business (17 November 2010).

[37] *Id.*

Finally, Russia is perceived as dependent on hydrocarbon production. Russia's budget is funded 35% by oil and gas "to the tune of 35% [and] without that income would have a deficit of close to 10%."[38] There is a fair amount of discussion that Russia is at risk based upon movements in the price of oil and gas – particularly as a result of the US shale play. Oil exports are in decline, as are gas exports to Europe. Increasing oil production is very dependent on investment and fiscal policy. Oil dependency is cited as a fundamental weakness.[39] In the area of market dynamics, the capital markets investor community is registering heightened risk.

The risk premium. This year's Sberbank Russia Forum program highlighted one of its plenary sessions by observing:

"There can be little doubt, based on consensus forecasts, that Russia's equity market is trading on substantial valuation discounts to both developed market and emerging market peer groups. A recent report from Sberbank Investment Research quantified the valuation discount to global emerging markets in the range of 25-50%. The same report also highlighted that Russia's equity 'risk premium' (the excess return that investors demand for taking on relatively greater risk) is materially higher than most peer group markets and that this risk premium has widened to a nearly 10y high over the past two years."

The "average" Russian enterprise that wishes to avail itself of resources from the capital markets or the "investor community" faces extra costs (sometimes called "risk premiums") and lower enterprise valuations that flow naturally from higher perceptions of risk. These "extra costs" permeate the entire P&L and the Balance Sheet of all

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[38] "Is Russia Ready for Life After Oil?" Forbes (3 October 2012).

[39] "Economy: Oil Dependency Remains a Fundamental Weakness", The Financial Times (20 June 2012. *See also,* "Putin Plays Down Russia's Deadly Dependence on Oil & Gas Revenues" Oilprice.com (30 October 2012).

enterprises involved – and they take the form of higher interest rates and transactions costs, more onerous terms and conditions of security and collateral, required future measures upon which ratings are dependent, and the list goes on. The societal cost is gargantuan.

Sberbank's Forum website indicates the results of the panel and the audience participation: "The moderator asked the audience to answer several questions. The first question was whether the Russian discount is justified. The majority said that it is justified. The second question was on what are the most negative issues contributing to the valuation gap. The most popular answers were treatment of minority shareholders (36%) and adverse government influence (28%). The audience was also asked what the government could do to assist the equity market to close the valuation gap, and 62% of attendees said that attacking corruption and bureaucracy is the best answer."

Among other negative drivers mentioned by the panelists were: capital flight and oil dependence; rule of law, predictability of the game and minority rights concerns; infrastructure; and, Soviet mentality, red tape and refusal to employ modern governance and operational process. Michael Shamolin – CEO Sistema - stressed how a number of companies with "brilliant" management, that were going against this environment were in fact trading at a premium to their peers. Thus, this eminent panel sees the direct correlation between the risk factors cited herein and the negative fortunes of Russian entities seeking access to the capital markets.

Moreover, commentators continually observe that these factors – and of course the general market -- have resulted in a slowdown of the Russia IPO pipeline.[40]Perhaps more

[40] "Russian IPOs in 2012 and Beyond", The Moscow Times (3 April 2012).

accurately, many observers keep saying every year since 2009 that the pipeline is about to run strongly again, and then, when it does not, others (or even the firms that keep saying the market is about to spring up again) that give explanations of why this or that IPO could not get off the ground [41]-- and the actual numbers reveal the slowdown. Of course, there are some notable exceptions where the IPOs did succeed (*e.g.*, Megafon, Yandex, etc. The situation begs the question: what can Russian enterprises do to improve their situations? Can aggressive attention to corporate governance be a part of the solution?

3. Does history give us any guidance?

Over 300 years ago, a mercantile class was evolving in Western Europe which required its own "corporate vehicles" to facilitate commercial life. This growth of a commercial class morphed the prior "royal charter" system into private corporations. Thus, the medieval common law concepts of courts and principle-agent evolved into the commercial construct of a private corporation. At the same time the UK was colonizing massive parts of the world – including what we now call America – the evolution of the private corporation was a vital legal construct facilitating all commercial and societal advancement. This aspect of the UK, more or less, to be "a civil society" spread throughout the world in varying degrees of strength, and for varying periods of time, to Canada, South Africa, India, Australia, New Zealand, parts of the Middle East Southeast Asia and Africa, the East Indies, Hong Kong, and elsewhere.

[41] "Another Reason to Stay Out of Russia", Business Insider (14 December 2010) – Sovcomflot: "Russia Helicopters: Hard Landing", The Financial Times BeyondBRICs (11 May 2011); "Political Risk Hovers over Russian IPO Market", The Wall Street Journal (12 May 2011): Russian IPOs: Case by Case", The Financial Times BeyondBRICs (16 October 2012) – Promsvyazbank; "Russia Rail Carrier NTS Postpones Share Sale Marketing", Bloomberg.com (25 January 2013).

The private corporation was an *essential* tool to support the industrial revolution. Between 1800 and the early 1900's, the story of corporate governance is the story of "corporate law", and the story of the spread of the industrial revolution. In supporting the move from mercantilism to the factory system of industry, the fundamental fuel was "other peoples' money". The nation-state's "deal"[42] or "rule of engagement" to inspire "other people" to risk their capital in industrial expansion, was to grant them "limited liability" for the liabilities that might be created by the corporation, as long as they kept their hands off management. Other people (shareholders) put their capital into corporate entities and, in the event the corporation went under, the shareholders' obligations were limited to the capital they put in. Likewise, as long as the shareholder was not simultaneously serving as an officer (essentially a principal) or employee (essentially an agent) of the corporation, the shareholder was not responsible beyond his capital for the wrongful acts or debts of the corporation. These concepts of corporate law -- sorting out the rules of the game between the investors and the management, between minority shareholders and other controlling shareholders, and between the investors and the outside world dealing with their corporation -- had little or nothing to do with the setting up, or the growth of stock exchanges.

Much of what we are calling governance today was nothing but the expansion (from state or regional laws and regulations which covered the people and entities that were domiciled in those states and regions) and modernization and application of these early

[42] It is not suggested that it was the case that somewhere in a situation room or at a negotiating table these policies were "agreed" or set forth in a plan. Rather, over the development of laws and through the evolution of the common law, since nations generally favor growth and power, these laws and interpretations developed to support these concepts of limited liability. *See* A. Kostyuk, Corporate Governance in A Transition Economy VirtusInterpress (2005) at p. 5. *See also,* U. Braendle and A Kostyuk, "Developments in Corporate Governance", VirtusInterpress (2007); R. Apreda, C. Gerner-Beuerle, A. Kostyuk, Corporate Governance: An International Outlook, VirtusInterpress (2011). Mr. Kostyuk is masterful at considering the historical and social implications of the past and future evolution of governance in emerging markets, particularly the CIS.

ideas to the stock exchanges (which were multi-state or national in scope – but which initially lacked any national or multi-regional regulation), or at a national or transnational law (rather than state or regional where they began). Many corporate operational and reporting systems were not born from abstract morals or principles, but as a way to fulfill the core corporate law mandates.

One of the other critical issues that was resolved in different ways in different places was a shareholder's right to sue – whether in that shareholder's own interests (a class actions on behalf of similarly situated shareholders) or in the company's (as a derivative right, derived from the company's best interests). It is not enough to consider whether a particular point is legal or correct under the securities regime of a particular jurisdiction.

Thus, the tendency to focus on the top level "companies act" principles is one of the reasons that the dialogue about corporate governance in Russia frequently sounds like a moralizing lecture. The SEC laws, SOX, etc., as well as the Combined Code and the Companies Acts, are all grounded on the core, underlying, jurisdictional corporate law – which is far more operationally grounded and pragmatic

The story about the evolution of corporations and corporate governance is also the story of the development of professions and professional responsibilities. For example, until after the invention of the corporation and the start of the industrial revolution there was no such thing as an organized accounting profession.[43] The first laws recognizing accounting as a profession did not occur in the US until around the turn of the 20th century. They were first established in the UK several decades earlier. Until after 1900 there was no such thing as GAAS or GAAP. In parallel with the evolution of corporate

[43] See, P. Ostling, "Under the Spreading Chestnut Tree: Accountants' Legal Liability – A Historical Perspective" Touche Ross University of Kansas Auditing Symposium (1986).

law and corporate governance, the duties and liabilities of professionals were evolving from the 1850's onwards. Again, this evolution began in the "common law" countries and moved outward.

To some readers, all of this may seem like a huge history diversion – however, even today, while other BRICS have well-established laws for the qualification of accountants, for example, Russia does not. Much of the evolution concerning the development of private corporations, corporate law, and ultimately, corporate governance, and their transmission broadly through the mercantile, entrepreneurial, bourgeois, journalistic, legislative and judicial classes over generations, never had the same development in Russia as they did in the common law countries – indeed, even as much as they did in places like Hungary, Poland, Czech and some other Eastern European societies.

The evolution of responsibilities of professionals forced the professions to develop standards of care and generally accepted practices. This had gigantic ramifications for corporate governance. As the liabilities of the accountants became more pronounced (*i.e.* their lawsuit losses began to cause professional pain), they reacted to create GAAP and then GAAS – in partnership with the NYSE (which had actually resisted this effort up through the Great Depression – as had the accounting profession until that time). Since the lawyers generally write the laws and then the lawyers become judges, the extension of the liabilities was slower to hit the legal possession – but it did. In the 1980's the liabilities then started to hit the banks for improperly lending miscreant corporations money that allowed these companies to prolong their lives and harm other members of the investment community. Since Russia has not developed a standardized qualification system of its own for accountants, for example, it has not developed the underlying enforcement principles, nor the behavioral expectations. Young Russians go elsewhere to obtain qualification stature.

This leads us to a brief consideration of the robber barons, mentioned earlier. The fact of the matter is that all of the post-1900 laws, and all of the governance concepts, and even GAAS and GAAP, were "invented" in the first place exactly to prevent and punish their excesses. The US Federal Trade Commission, the Federal Reserve Board, the Sherman Antitrust Act, the Clayton Act – and many of the early US labor laws, were all in response to the monopolistic/oligopolistic behaviors of the robber barons and their progeny. The story of the formation of Morgan Stanley and JP Morgan is, in fact, an aspect of the regulators' wrath in this era.

The rules of the New York Stock Exchange that required that registrants publish annual financial statements – the more stringent listing rules of the Exchange – as well as the first efforts at GAAP, and shortly thereafter GAAS between 1929 and 1933, were a direct reaction to the 1929 stock market cash and the excesses of the financial class in the Roaring 20's. The 1933 and 1934 Securities laws was a further step in this reaction.

Thus, the legislation of the 30's that is so often referred to by so many as being the driving factors that brought corporate governance to the fore were not *sui generis*. Indeed, they were simply another evolutionary step in the development of "rules of the game" to both facilitate the formation and efficient distribution of capital (like the industrial evolution era corporate law developments were one century earlier) – they reflected measures to contain the risk and control the amplitude of economic cycles in the context of capital markets that began to become more globalized and more available to the masses. A similar but different story could be told about the evolution of the laws and the culture around corporate governance in the UK.

In the eighty years since the passage of the US Securities Act there have been significant ups and downs in the economic cycle and in both the US and the UK over that time great financial scandals. In both countries, these failures have been addressed through further legislation intended to reign in bad corporate and banking behavior and to increase the accuracy of reporting, and to expand good governance. Not all of this legislation has worked as well as had been planned or hoped. In each case, however, great failures have been utilized as the opportunity to further evolve the rights of the investor community and to abate the risk that had been observed in the markets.

In the late 20's and 30's in the US there was a great deal of media attention and public concern over what was perceived to be the corruption of the system and the influence of the robber bandits, and parts of the banking and investment systems. Similar commentary exists today in the US and the UK about the banks' behaviors leading to the Great Recession. Russians do not need the foreign press or expatriate professionals to turn their attention to the problems of corruption or Russian risk. They are the first to notice and the first to complain. It is impossible to read the Russian press these days and not see coverage about the efforts of the president's administration to combat corruption. We may debate the extent or the aim of the focus on anti-corruption, but it is top of mind within Russia at every level of society. The open question is: how can the Russian regulators turn this popular energy about fighting corruption into a "push" for corporate governance. The history of steps taken in the US and UK that were focused on the elements of core corporate law, as well as the regulation of the professions, present fertile areas for consideration in today's Russian context. If Russia today has the popular interest from its citizens, is there not some way to include the idea that corporate governance and the "tone from the top" that true governance requires, is an antidote to some of the ills that society is concerned about?

The interplay between the evolution of corporate governance and the development of "professional standards" and professional liabilities is particularly low hanging fruit. In the US and the UK there has been far more work done on the concept that the professional bodies are "companions" to national regulation of corporate behaviors. In the US for example there is the American Institute of CPAs, as well as the American Accounting Association, and there are state analogs to these professional bodies at every state and even within some large metropolitan areas. There are the American Bar Association, states bar associations, and large city bar associations. Through enforcement and regulation and self-interest, all of these bodies (as well as "independent directors") have accepted the idea that they are individually and collectively responsible for helping to ensure good governance, good corporate standards of transparency – including through institutions such as the Financial Accounting Standards Board – and can lose their licenses their money and their freedom it they fail to meet their professional standards.

For many decades, these professional bodies – in an effort to maintain their self-regulation – created processes to ensure that their own professional standards (and in the case of peer reviews, their actual individual and firm application of those standards) supported the aims of governance, transparency, good financial reporting, preventing fraud and losses, and disclosure. There are a wealth of reported cases where the courts punished these professionals (accountants, lawyers, directors, etc.) when they failed to meet their obligations. National concerns about whether the accounting profession was doing enough led to the formation of the Public Company Oversight Board (at the time of SOX) to oversee the performance of CPAs in their performance of public company audits. PCAOB oversees a process that includes peer reviews, even of the audits of SEC registrants that are conducted, for example, by Big Four audit firms in Moscow as to their SEC registrant clients.

In addition to the professional organizations within countries, such as the US and the UK, these professional bodies eventually led to the development of transnational professional standards such as the International Accounting Standards Committee that became the International Accounting Standards Committee. The IASC and the IASB have been partners along the journey to develop convergence, for example, between international and USSEC GAAP financial standards.

Much of the story of the development of corporate governance over the past 20 years has related to the development of international financial and international reporting standards. What is the point of this to Russian corporate governance? It seems that much of the fault for the failure of corporate governance to have evolved more dynamically over the last 20 years in Russia is because of a lack of development of these professional institutions. Accountants, lawyers and bankers practicing in the US or the UK or the Netherlands, for example, live in much greater fear of the regulators for issues relating to the fulfillment of their professional standards, than do their analogs in Russia.[44] The average US accountant

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[44] *See* "New Money Put City's Reputation At Risk", The Financial Times, supra n. 6, where The FT, in criticizing the "opaque governance" of the emerging markets companies and the weak standards under the LSE's comply or explain regime, observed that many of the "latest newcomers [from the emerging markets] quickly recruited members of the City establishment to their boards, including knights of the realm, Lords and senior executives from some of Britain's best known companies." Companies in Russia sometimes were looking for a useful name with a noteworthy CV and title – call them rent-a-lords – who would join the board shortly before the IPO and come to three or four meetings a year, not cause too much trouble, and provide governance "cover" for the IPO. The fact that these token directors felt

in Russia is far more concerned with the SEC or the PCAOB than about some Russian analog (this relates to the point made earlier in this article, that governance in Russia has been more about the "pull" toward governance from the sources of "other peoples' money" for Russians from the external capital markets, than it does from a "push" from within Russia's institutions). Others have expressed that their experience with Russian lawyers and accountants is the same. For the sake of improving corporate governance in Russia, and for the benefit of our clients and all Russians, much work needs to be done to develop and breath life and give teeth to the professional standards and the professional organizations. It is time for the professionals to step forward and accept a substantial portion of the responsibility to create a real "push" for governance coming from within Russia.

Another element in the wider "push" for corporate governance that is very different within the history of the subject in the US is shareholder activism. The laws of the US, as well as the judiciary in interpreting those laws, have established the place of the individual shareholder as an important element of the enforcement process. Under state (*e.g.,* Delaware) laws, the shareholder has certain rights to see the books and records of the enterprise, as well as to press his or her shareholder rights in actions against the corporation. Some of these are derivative to the interests of the company – in other words, the shareholder stands in the place of the company on behalf of all shareholders to press some right of the company (often against management or the majority). Both the 1933 and 1934 securities acts provided claims to investors, 10b(5) being the most

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almost no downside for their service was one of the problems in Russian corporate governance. This practice created low expectations. They feared no hard work and little risk. Directors should be *expected* to provide *real* value to the enterprise. It should be *hard* work. There should be some feeling of *risk of failure*. There are so many excellent and hard working Russian and expatriate directors in Russia today, including knights and lords, who are working tirelessly and want there to be real standards and real accountability. They also resent the negative reputational besmirchment from these faux directors.

famous. There are claims for private litigants under panoply of laws, such as the Racketeer Influenced Corrupt Organization Act ("RICO"). There is no doubt that there was abuse of these rights of redress, and the courts and the legislatures have spent time over the last 15 years pruning back some of the excesses of the class action bar and its client base. Nonetheless, shareholder and consumer activism have been in the vanguard of the development of corporate governance in the US for over 50 years.

Turning to Russia, again as an observer, one has the sense that consumer and shareholder activism are well out of favor as instruments for creating the "push" for governance. One would hope that the powers at be would be able to distinguish between those types of shareholder activism that are driven to advance the cause of transparency, governance and integrity in private corporations, from those that are perceived to be "political". In April, at the Sberbank Russia Forum, E. Novokreschenykh stated that "the protection of minority shareholders is a crucial problem. Minority investors should become a 'holy cow" on the market, but [she said] there is no political will to solve this problem." Albert Ganyushin agreed with this point about minority shareholders, but added that "investors feel that the government could do something to protect shareholders, but see little progress in this area." If Russia cares to improve its corporate governance, it seems that this is a ready made area for enlisting the willing support of their populace.

Of course, the idea of strengthening shareholder rights and investing shareholders with more tools and more rewards to act as citizen prosecutors will be as popular with the controlling shareholders and their professional representatives as grapeshot. The question is very simple: is it time to change the paradigm and tilt the table slightly in favor of the hand of corporate governance, transparency and integrity? Another relevant question is: if

Sberbank is correct, that Russian businesses face extra burdens that prevent some listings, if the risk discount is up to 50% of market capitalization,[45]do the defenders of the current status (against at least some degree of shareholder rights and activism) have more to lose or more to gain from such a change?

These and other systemic changes could all serve to improve the governance situation in Russia and reduce the risk discount.

4. What should be done at the entity level?

Irrespective of possibility systemic change, there are steps that Russian enterprises can take (whether or not they are yet listed) to individually improve their own reputation around governance and risk – and these steps will create a competitive advantage for those who take serious action. In the current environment, where there is incredulity and some bad governance, those companies that stake a claim to "good corporate governance" become the positive outliers.[46] What are the steps that companies should take, and good companies like Evraz, MTS, Uralkali, Polymetal and Polyus Gold – and others in Russia have and are taking today? What pragmatic actions should professional advisors be counseling?

There is a frequently understated aspect of corporate governance: the very fundamental tools of "corporate governance" that the board and its committees utilize to oversee and monitor (and which the executive and management utilize to actually operate the enterprise) are essentially and actually nothing more and nothing less than "good

[45] And, if all those who are saying that capital flight is an issue, if FDI could *potentially* be higher but we in Russia are underperforming according to the experts, are correct, and if the costs of Russia the risk premium percolate throughout the balance sheet and the P&L to some extent in credit and other transactions because of higher costs, fees and relatively adverse terms, does the overall improvement of the environment and the economy not help to defray the costs of the change?

[46] But keep in mind that no amount of good governance makes a bad business model good.

business”. Too much time is spent wrapping “great moral precepts” around corporate governance, when fundamentally it is really about making more money and creating more shareholder value. To make the point, consider several typical committees and the actual mechanisms they utilize in order to carry out their own responsibilities as directors in a “well-governed” corporation. The Audit Committee is charged with oversight on behalf of the board over the financial matters and risk matters of the enterprise. To carry this mandate out, every audit committee interfaces with the financial team inside the company, and externally with the financial and legal advisors, such as the independent auditors. But, what “systems and processes” does the audit committee actually monitor and oversee in order to accomplish this mandate? Every audit committee worth a kopek insists on adequate financial management systems, adequate financial management systems are founded upon adequate controls and reporting capabilities. Every corporate decision normally requires an assessment of risk and rewards – and properly assessing risks and rewards in a corporate entity normally requires a useful risk management system. Determining controls’ and processes’ capabilities to assess risks and control loss normally requires some form of internal and external auditing and risk mitigation plans.

If one looks at a typical remuneration and positions committee mandate, one winds up at a similar tangible and bedrock place. Simplistically, the R&P committee is helping the board to make director and senior management selections and board and senior management remuneration decisions. And, practically speaking, the R&P committee process is probably among the worst areas for Russian companies, in terms of a lack of understanding of how R&P committees should add value. In a well-functioning and well-governed board, the R&P committee has a fundamental review in reviewing and approving (and bringing to the board as a whole) the HR strategy of the enterprise: does the company have the people it needs today and tomorrow; how will it get them; are the salary, bonus and stock incentive plans of the company calculated to obtain and retain the people with the skills to effect the business plan; do those pay plans adequately motivate those people; are there proper corporate and individual KPI's; will the meeting of the annual and longer term KPI's support the meeting and exceeding of the business plan; are there proper systems of performance evaluation, goal setting, and succession management, etc.

The tasks of the audit committee and the R&P committee are not some esoteric and philosophical "do-gooding". A good committee should be meeting throughout the year with the team that has the responsibility for these very hard and real corporate systems. Audit committee meetings of many of the advanced state Russian companies include the CFO, the internal auditor, the ERM director, and the corporate security director. The CEO is generally present for at least half of every meeting. Circulating through the meetings periodically are the external auditors, the corporate counsel, the IT director, and the financial reporting department director. There are meetings and conference calls one off with the auditors, the CFO and others. It is a relationship based upon meeting the plan and preventing loss of shareholder value. Similarly with R&P committee's meetings having not only the HR director, but also the CFO and the CEO,

and the external compensation and other advisors. This committee should be working as well with the chairman of the board on an evaluation of the board itself and its members. One could similarly consider what a Strategy Committee does and what hard-edged corporate systems it should oversee, as well as for all of the board committees.

If a critical evaluation of what a board really should do is undertaken, and if the corporate advisors actually proactively broadcast what a board does in practice, the moralistic views fall away. Well-governed boards are not the realm of rent-a-lords. Board members should be obligated to be continually engaged and contribute in a very measurable way to shareholder value – or, they are a waste of money. It is time for the professional community in Russia to emphasize this element of what good corporate governance is. It is not a moral precept. It is good business. Good Russian companies already get this. For the most part, successful Russian business people will relate much better to the value proposition of what good corporate governance can do to contribute to shareholder value than they will to the more philosophical and esoteric ideas that are founded on social responsibility. A well-governed board then, by overseeing and insisting on the very normal corporate structures that support good business operations, and carrying out these functions with integrity and the required element of independence, will result in a corporation with good corporate governance, transparency and integrity.

Accepting the governance challenge and treating governance like a value proposition. Some advisors in Russia still act as though corporate governance as well as the corporate systems that evidence first class operations that support governance, like a "loss leader", instead of as a value-enhancing focus of investment. Evidence of this is attitude is that some of them permit too many of their clients to "wait" until just months before the IPO process commences, before getting serious about governance, a board and board systems.[47] When a company is serious about the governance challenge, it appoints

[47] This may happen because professionals may not take a company's underlying readiness for the IPO seriously, and therefore they do not want to appear too "pushy" to a client that may not even understand the implications of the Russia risk discount (indeed, it may run exactly counter to the assurances that some professionals may give about how well the IPO process will go for the hopeful). There are situations where – because the professionals do not really believe that a company is "close" to the public market point – they assign their less IPO- and less capital market-savy personnel to a

sufficient non-executive and fully independent non-executive directors (at least one of whom is qualified as a financial expert under the rules of the target listing jurisdiction – and it helps if another is an industry subject matter expert). Leading companies in Russia who have been committed to compete on the basis of better governance also appoint an independent non-executive chairman. And, these leaders ensure that the audit committee is fully independent immediately, and move to an independent remuneration committee in short order.

Companies that wish to develop a distinguishing reputation for good corporate governance make that commitment – to the investor community, to their broader shareholder base, to the rating agencies, to their banks and professionals. For example, they hire a first class and experienced Investor Relations leader and give this individual the mandate and permission to proactively communicate their commitment to the market.[48] Among other things, these IR functions work to leverage the governance successes into the market. This means, from time to time, facilitating meetings of their INEDs with representatives of the investor community and the rating agencies. These companies take the appointment of the independent directors as a very serious investment. They utilize the talents of the best search firms and seek individuals whose name and experience for integrity and governance will indicate the governance commitment to the capital markets. They have formal agreements with the directors that set out the serious commitment they expect from these directors. They ask for and expect that the directors will serve as mentors and facilitators to help develop the senior level

particular company. These individual, who have never actually served on a board, and may never have actually gone through the capital markets process, are not really able to "Coach a game they have never played".

[48] Both and MTS and Uralkali – and a growing number of Russian leading companies -- have made significant investments in first class investor relations – which includes affirmative outreach to the investor community and the stakeholders, and expressly acknowledges the seriousness of the focus on good corporate governance.

executives of the company. They ask for and expect that these directors will bring the benefit of their years on relevant financial and business experience to help upgrade the operating, financial and reporting systems of the company.

Sometimes, the controlling shareholders and the executives of Russian entities are so busy setting out the limitations of the board's and the NEDs/INEDs' "interference" with "management" or the "controlling shareholder's natural areas of influence" that they emasculate the effectiveness of the board and risk turning the INEDs into decorations. This is the exact opposite of corporate governance. Advisors should be much less sympathetic to these control instincts if they are serious about maximizing the market capitalization of their clients.

Corporations that want to lead in the area of corporate governance devise real structures to live this commitment. They develop a strong tone from the top on all the integrity and transparency issues. They develop, ahead of time, process for the board's utilization of the INEDs to review and approve all related party and interested party transactions. Everyone knows these are a reality in Russian business. But, to create a well-governed process that shareholders can rely upon is both a risk containment mechanism and a transparency-enhancer. They sometimes place the emphasis on their commitment front and center in their annual reporting and in their websites.[49] These companies consider the creation of committee structures that emphasize good governance: for example, instituting a "governance" committee that has a mandate to focus on all of the governance considerations and to make recommendations for continual improvement in governance. These companies take into consideration the special limitations on voting and director nominations that apply in Russia. Until these laws are changed, companies and groups of

[49] Uralkali is a very good example of this practice.

controlling shareholders that are truly committed to governance can utilize the Positions or Appointments Committee as a real committee. In some cases, as a result of the limitations on minority nominations, these committees could become a decoration instead of an instrument for governance. Well-governed companies make use of the "special committee" concept comprised of INEDs (and to whom the deal professionals actually report) when the company is considering major transactions or where the deals may have the appearance of related party transactions. The special committee then does all of the pre-work on the transaction, and takes the deal to the board with a recommendation, where the various voting regulations dictate who may participate in the approval process.

Well-governed companies utilize their board committees to do real and continuing work. But more than this, they strive to turn the board meeting into a forum that fosters the exchange of ideas and discussion of the real agenda of the company. Boards should be more than an hour long sit-through where a chairman reads through a prepared script and the directors are expected to say "yes" five or ten times and go home. It takes approximately two years from startup for a board to function as a board and not simply as an echo chamber for the controlling shareholder. A description for the typical control-oriented entrepreneurial Russian enterprise that is not utilizing a board, and has not yet really delegated authority from the Chair/CEO-controlling shareholder to a "really" in-charge and strong executive team, is the "octopus system" wherein the controlling shareholder(s) seeks to utilize all his or her tentacles to control every facet of the enterprise.

It takes a fair amount of time for these controlling shareholders to develop the level of trust and familiarity to begin to loosen their grip and move to a more delegated, governed enterprise. This state when the controlling shareholder has learned to rely on a board, but stays on as the Chair, could be called the "shark" system. To move from the far right, octopus, system along a continuum to a truly "governed entity" takes real commitment and real effort. It is also only at this further point along the continuum that the board is functioning as an organism that can provide real value and can contemplate the serious issues that the company faces. Until this level of maturation has actually occurred, the board is not performing as the investor community hopes, and it is sometimes acting more like a fig leaf to cover lack of governance progress. Too many professional advisors provide no healthy tension to move their clients in the right direction on the continuum. If they are fearful of the reaction of their "shareholder(s)" there are organizations and firms in Russia who will provide a structured process to move from their client from octopus to at least shark. It is somewhat ironic that most of the professionals who are hesitant to force the governance paradigm on their clients have these types of consultative services within their own organizations.[50]

If our clients are having difficulty getting through the IPO process, and if good corporate governance can ameliorate this difficulty – and if even successful Russian registrants are suffering a serious risk discount – is it not now *time* for us to advance the governance agenda as a value proposition for our clients? Can this not be a competitive advantage for our clients? Can this not become a competitive advantage for the professionals? Are we not short-selling our clients until we have the courage to force the issue?

Addressing the High Risk Areas. If an entity wishes to try to address wide scale investor concerns along the lines of the risk factors cited in the media and by investors, it

[50] A well-governed board should have a formal process of goal setting for the board – and for the advancement of the company's governance evolution – as well as a performance management system. Seriously well governed company's share the results of their process in some appropriate manner.

can take individual internal steps to show that it is mindful of the mega-issues, and at least within its own ambit of control, it has taken steps to reduce the potential impact or concern. The suggestions below are only a sample. Every company committed to using corporate governance as an advantage should be able to sit with their INEDs and professional and craft a series of structures, processes and reporting processes that can address these risk areas.

- Rule of law concerns – can be addressed with the express commitment to corporate governance described above, but also indicia of the rule of law inside the entity are those that expressly address the concerns of minority shareholders. Proactive dividend policies are expected in advanced and well-governed companies. Attention to disclosure around all of the internal "rule of law" issues on a regular basis calls for proactive and transparent reporting. These companies anticipate the issues that may concern minority shareholders and the capital markets and report in a timely manner.

- Corruption risks – always begin to be addressed by stressing the tone from the top, and can be addressed further with a forthright anti-corruption policy and system. Any good law firm or accounting firm can provide the foundation for these. They include value statements, policies, whistleblower/hotline systems, compliance management, linkage to the enterprise risk management and internal audit and security systems. There is a tendency in Russia and in Europe to put down SOX. However, SOX-like commitments to internal control environments and the testing of the adequacy of controls is, indeed, an antidote to corruption.

- Capital flight / FDI concerns. At the entity level, the antidote for these concerns is a clear CAPEX and investment model. There are some analysts who have developed an idea that within certain industries within Russia (and Russia as a whole) have focused on short term growth and short term profits. Entities should understand this concern and factor it into their investment models and be sure to communicate this in the appropriate manner. Many advisors also recommend to their companies that they have a strategy for outside-in credentialization along the pathway to the IPO. Two of the best ways to accomplish this are to float a bond, particularly a Eurobond, and to consider a minority private placement with a reputable major investor group, particularly an EBRD or IFC (or someone like Macquarie). The double benefit of these transactions is that institutions like these will also begin to demand appropriate corporate governance, and they will speed up the evolution. Steps like these show an entity is serious about staying power, meeting bondholder indenture terms, and dealing with a substantial and sophisticated minority shareholder.

- Market dynamics concerns. An entity's commitment to first class governance and operational systems helps the investor community to understand that this particular company is trying to become a leader and trying to develop efficiencies and economies. At several points in this article the point has been made that corporate governance is more than an esoteric or moralistic point of view. It should drive the corporate systems that allow management and the board to steer the ship at a cost that is more efficient than the competition. Chief among the systems that should be focused upon and communicated in corporate reporting are those that are aimed at human resources and people strategies, information technology and reporting infrastructure and corporate social responsibility. Too few Russian entities have begun to understand the power of being among the few within Russia to address corporate social responsibility (*i.e.* the environmental, health and safety, anti-corruption, support of the communities, developing the enterprises human potential). Indeed, addressing CSR, by definition is providing an entity level response around the demographic and societal concerns at the heart of some of the areas of investor risks.

Certainly, there are other steps and strategies that enterprises can take to compete to show there governance is better than other Russian companies. The disclosure of more than the required minimum about board compensation is an area for consideration. For companies that are not required to fully meet even the more limited LSE "comply or explain" standards because they are filing GDRs, those companies can still use the "comply" standards as their target and report on their progress to achieve compliance. There are a host of possible areas to consider. The journey, however, commences when the enterprise determines that there is a business case for competing on the basis of good corporate governance.

5. Conclusion

Rome was not built in a day, and neither will the Russia risk discount be substantially reduced in the short term. On a systemic level, substantial reduction across the piece will require systemic solutions. Systemic solutions are above the pay grade of the author and most of the readers.

Until that systemic solution set is implemented, however, the fact of the risk discount and investors' perceptions about risk in Russia actually present an opportunity for those companies which are willing to compete to reduce their discount -- through competitively demonstrating they are among the “select” who seek to reduce their enterprise risks and to court the investor community by recognizing and addressing investors’ concerns.

Some entities in Russia, while they think differently, and may even be told differently, will never make it through the IPO challenge unless they proactively accept this governance challenge. Why would smart business people leave up to half of their market cap on the table?

This is the value proposition for good corporate governance in Russia. Russia and Russians deserve that we in the professional ranks and who are supporting the entrepreneurial class recognize and articulate this value proposition. It is time to start investing in good corporate governance.

Finally, if we take these steps and we create a class of those companies within Russia that has made this commitment and has accepted this challenge, over a reasonable period we will create a critical mass of role models who can at least help create the critical mass that can support real positive systemic change.