

**MODERN CORPORATE GOVERNANCE  
IN RUSSIA AS SEEN BY FOREIGN  
BUSINESSMEN AND EXPERTS**

**Findings of Survey held by National Council  
on Corporate Governance  
and Russo-British Chamber of Commerce**

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## SURVEY DESCRIPTION

The issue of corporate governance is decidedly international in character, being closely linked to the globalisation of financial and commodity markets, and the cross-border movement of capital. Accordingly, discussion concerning the current state and future development of corporate governance is by no means restricted by national boundaries. In particular when speaking of Russia, it seems appropriate to widen the angle of opinion on issues of corporate governance by taking into account the expert opinions and observations of foreign business representatives operating in our country.

In November/December 2009, in cooperation with the Russo-British Chamber of Commerce (RBCC), Russia's National Council on Corporate Governance (NCCG) conducted a survey **among foreign businessmen, managers and experts** associated with Russian business. The topic of the survey was the latest trends in the development of corporate governance in Russian companies, and in particular the impact made by the global financial crisis in this regard.

The study was carried out by sending written questionnaires to three categories of respondents: 1) Russian company board members, 2) senior managers of Russian companies, 3) heads of the Russian offices of foreign business associations and companies, especially those involved in investment, law, audit and consulting. The scope of the questions varied slightly depending on the category of the respondent. Some questions were closed, giving respondents a choice between several pre-formulated answers; others were open-ended, offering the chance to give a detailed response.

In terms of content, the questions included in the questionnaire can be divided into several sections. The first section required an overall assessment of the business environment in Russia, including a description of business practices and management culture, and an evaluation of the impact of foreign sharehold-

ers and investors on corporate governance in Russian companies. The second section explored the relationship between the global financial crisis and corporate governance. The third section asked questions on the key problems faced in Russia by foreign investors and shareholders. The fourth, final section focused on issues related to the actions of the board of directors and independent directors in Russian companies.

The study included representatives of several major Russian and foreign banks, companies and organisations, including Alfa-Bank, Rosbank, Raiffeisen Bank, UniCredit Bank, Deutsche Bank Ltd, Danske Bank, Financial Corporation Sistema, Novolipetsk Steel (NLMK), Severstal, Pipe Metallurgical Company (TMK), Siemens, OMZ Group, IDC Holding, OGK-5, TGK-1, Sibur Holding, Ilim Group, Wimm-Bill-Dann Foods, Deloitte, KPMG, Baring Vostok Capital Partners, Denton Wilde Sapte LLP, and the Association of European Businesses in the Russian Federation.

The responses received provide sufficient material for a qualitative analysis and, in our opinion, some interesting generalisations.

The NCCG and the RBCC would like to thank all study participants who took the trouble to fill out questionnaires.

In respect of the need for confidentiality, all references to answers from individual respondents are kept strictly anonymous.

The NCCG and the RBCC are grateful to KPMG, MICEX and Ilim Group for support in publishing the findings of the survey.

# 1

## ASSESSMENT OF THE RUSSIAN BUSINESS ENVIRONMENT

Before examining the views of foreign experts on the various aspects of corporate governance and specific factors in its development, it seemed important to get an idea of their overall perception of Russian business practices, which largely determines the nature of particular assessments. In this regard, respondents were asked the following broad and open-ended question: ***"To what extent are Russian business practices and management culture consistent with international standards? In which aspects do the two most coincide? In which areas does Russian business culture still differ significantly from international norms?"***

Evidently, our experts found this question interesting; of all the questions, it elicited the most expansive replies. The responses received can be divided into four groups. In the first, small group, a **predominantly critical position** is expressed. Its essence is that business conduct and management culture in Russia correspond either very little to international standards (and then only in companies which have Western shareholders), or not at all. As memorably expressed by one participant in the study, "Russian business behavior and practices conform the international standards to the extent that business is there to make a profit, and harmonization takes place when it suits the Russians." The same idea was expressed in milder form by another respondent: "Even in large companies, run by Russian executives educated in the West, business behavior and management culture are often influenced by so called local specificity."

Those who take this position believe that Russian businessmen entirely underestimate the benefits of high-quality corporate governance. Many managers are simply unable to comprehend how implementing modern business standards can improve the effectiveness of a company. Management techniques remain rigidly centralised and based on a strict hier-

archy. The concept of using a team approach to solve specific business problems is developing very slowly in Russia. According to one expert, "many company heads prefer to stick to the old, in fact Soviet type of business culture, in which the CEO was the only authority and nobody dared to argue with him or her." Russian companies frequently use the board of directors as a tool for implementing the policies of particular owners, which discredits the very purpose of the board of directors as an institution. Equal treatment of shareholders, especially in large companies, is seldom observed.

**Big business in Russia is based on power, political connections and corruption. Ethical behaviour is present to the extent it furthers business interests. (Senior manager of a major Russian bank)**

The most striking differences between business culture in Russia and the West occur in such areas as human resource management, the conduct of negotiations and compliance with contractual obligations, openness, honesty and transparency in conducting business. This position was expressed most bluntly by the author of the above response: "Big business in Russia is based on power, political connections and corruption. Ethical behavior is present to the extent it furthers business interests."

A **generally positive attitude** towards the current state of Russian business practice is expressed in a second, similarly small group of answers. According to this position, the integration and expansion of Russian business into global markets has seen a substantial improvement in terms of the business practices and management culture of domestic companies, and their degree of compliance with international stand-

ards. This process has been accelerated by IPOs of a number of major companies on leading world stock exchanges, with their stringent quality requirements regarding corporate governance. Thus, over the last 5–10 years the level of corporate governance in most large public Russian companies has grown considerably.

**In our company, we do not operate any differently from international standards. (Senior manager of a major Russian company).**

Notably, two respondents in this group (one senior manager and one independent member of the board of directors from different Russian companies) indicated that their company business practices are not fundamentally different from international standards. The second of them went as far as to add: “The directness of conversation at the board of directors level is probably the biggest difference from international norms. In Russia, it is more direct, which I find good.”

The vast majority of answers to this question belong to a third group, which represents an **intermediate position**. The latter entails the recognition of, on the one hand, significant progress in moves by domestic companies towards developing international business standards, and on the other, the continuing existence of important differences. Two experts gave integral estimates of conformity: in one case, 30–40%; in another, 60–75%.

In which areas do supporters of the intermediate position see a convergence of Russian business with foreign patterns? They note that the legal and regulatory framework, norms and rules of business conduct, are already largely in line with international standards, though company behaviour changes slowly. At last, abiding by the norms of the Joint-Stock Companies Act has become the obvious thing to do, and the protection of the rights of minority shareholders is becoming a significant factor in the model of corporate governance. In terms of changes

in business practice, a notable development in Russia is the new generation of bright, young business school graduates now entering the market, marking the emergence of “open, unbiased teams of senior managers”.

According to respondents in this group, harmonisation is most visibly manifested in the following aspects:

- Increasing transparency of financial reporting and rising standards of disclosure as a whole;
- Improving business planning, including strategic and financial planning and management of cash flows;
- The development of comprehensive investor relations;
- Improving internal control procedures for the preservation of assets, and to avoid fraud and corruption;
- A reduction in the number of questionable transactions with affiliates;
- The employment by large Russian companies of highly reputable international auditors and authoritative independent directors;
- Increasing trust between company top management and the personnel department regarding the recruitment of highly skilled managers;
- Strengthening correlation between senior management compensations and company performance.

**In terms of harmonisation of business practices the most notable phenomenon in Russia is the new generation of bright young business school graduates now entering business. (Senior manager of a foreign law firm)**

At the same time, responses in the third group reveal a decidedly long list of discrepancies between typical Russian business practices and adopted Western standards. Among these differences the following should be highlighted:

- The legal and accounting environment in Russia is less favourable for business than in many other countries (especially Anglo-

Saxon), which in turn has an adverse effect on corporate governance;

- Transparency, despite improvements, is still at a modest level;
- Managers’ accountability before the shareholders, including minority shareholders, has not yet become the norm and is not fully respected;
- The top management of Russian companies has not put into practice the idea of respecting the rights of minority shareholders and, in particular, considers transactions with affiliates on non-market conditions to be quite acceptable;
- Deals are often presented to the board of directors for consideration at a later stage, due to the perception that it is the board’s job either to approve or not approve a deal, but not to take part in the formulation of its terms;
- Managerial culture in Russia continues to be dominated by centralised leadership “from above”, without the delegation of authority or the formation of matrix structures;
- In Russian business culture personal factors and secrecy are too heavily pronounced;
- Corruption continues to be widespread, even in private companies;
- Contractual obligations are not always honoured;
- The level of aggressiveness in the Russian business environment is much higher than usually found abroad (“this does not mean that all Russian businessmen are personally aggressive but they have to cope with others who are”);
- Insufficient attention is given to personnel development;
- Optimisation of operations is still too formal, and far behind Western practice.

It does not take long to notice that often the state of the same particular aspect of corporate governance in Russian companies is viewed positively by some experts, but negatively by others. It would seem that this is due to the varied nature of the domestic business environment, as well as the fact that adopted modern principles of corporate governance are not yet well-established, and are often combined with recurrent use of old practices. One can assume that our experts working at Russian

companies encounter differing realities within their corporate structures.

It is worth noting two important observations contained in this group of answers. Firstly, for all the ambiguities of corporate governance in private companies, state companies lag far behind them in terms of business standards. Secondly, the positive trend in the development of business practices in Russia has slowed considerably due to the fact that the global crisis has made foreign capital less accessible and therefore reduced the benefits derived by companies from moving towards the international standards.

Finally, the fourth group consists of answers expressing the position that **generalisation is not applicable** in this case, as “everything depends on the particular company.” It is interesting to note that in one reply the existence of set international business standards was itself questioned. Experts note that the level of compliance with Western norms in different companies varies considerably, as Russian business practices and management culture are largely determined by human factors, namely: personal characteristics of a particular owner or senior manager, his level of education and knowledge of international standards and practical aspects of management. Pronounced assimilation of foreign norms is usually observed in multinational Russian companies, where foreign shareholders wield powerful influence.

Connected with the last remark is the second open-ended question of the first block of the questionnaire: “**How would you assess**

**The generally positive trend in the development of business practices in Russia has slowed considerably since the global crisis has made foreign capital less available and therefore reduced the rewards for reform to individual companies. (Member of the board of directors of a major Russian company)**

**the impact of foreign shareholders on corporate governance practices in Russian companies? In which areas of corporate governance is this effect most pronounced, and in which, on the contrary, is it lacking?"**

As in the first case, the answers fall into several groups, and again we see here a group of sceptics, a group of optimists and the intermediate group.

Russian companies "improve" their corporate governance in order to attract foreign capital. In reality, the owners govern their companies as they like and the bulk of what the international world sees is window-dressing. There are very few exceptions. (Senior manager of a major Russian bank)

The sceptics form the smallest group. They believe that **the influence of foreign shareholders is negligible**. According to one of them, foreign shareholders can exert influence when allowed to do so by the majority shareholder or, in the case of state companies, the Russian state in the form of various agencies. Such influence can be seen only when a particular decision requires a three quarters majority vote, which is rare. At operational level and in management board practices noticeable changes are in most cases absent.

Another study participant is convinced that the influence of foreign shareholders on corporate governance practices in Russia is "practically zero". In his opinion, "Russian companies "improve" their corporate governance in order to attract foreign capital. In reality, the owners govern their companies as they like and the bulk of what the international world sees is window-dressing. There are very few exceptions." Another respondent pointed out that since foreign shareholders usually make up a relatively small minority, and as access to foreign capital has diminished dramatically as a result of the global financial crisis, their influence is considerably reduced. From his point of

view, the conflict within TNK-BP and between VimpelCom and Telenor are two examples, showing that foreign shareholders are at a distinct disadvantage.

In turn, the group of optimists believes that **foreign shareholders have significant influence**. They note that, thanks to foreign investors, Russian market participants, regulators and judicial bodies have been exposed to "the best internationally recognised practices of corporate governance". In their view, the influence of foreign shareholders usually brings greater openness and understanding of long-term goals to Russian companies, which, in turn, leads to the development of new skills, increases efficiency and improves business results. They facilitate the introduction in Russian companies of modern technologies and business models, thus increasing their competitiveness in global markets. Under the influence of foreign shareholders, standards improve in such areas as investor relations, internal control and auditing, financial management and risk management. Their presence has greatly contributed to raising of transparency of Russian companies. In particular, they are making a tangible contribution to the development of such institution as the audit committee under the board of directors.

Consequently, the position of the optimists is diametrically opposed to the sceptics' view. This may give the impression that our experts are talking about different realities. In this regard it should be noted that whilst all the sceptics are working for Russian companies, among the optimists there is not one who works for a company with a majority Russian shareholder. It is possible that this fact seriously imposes on the respondents' perceptions. The most significant group comprised representatives of the intermediate position, who believe that **the influence of foreign shareholders is significant, but not universally so**. They are convinced that the success of foreign shareholders depends on the extent of their participation in the share capital of a particular Russian company, as well as their ability to adapt to the peculiarities of the business climate in Russia. According to one expert,

"the influence of foreign shareholders is most pronounced in those companies where Western experts are invited to join the board of directors and executive bodies and contribute actively to the work of the company."

As regards references to the concrete results of foreign influence, they closely overlap with responses on the areas where corporate governance in Russian companies most closely coincides with international standards. These are: improvement of auditing and financial reporting, compliance with rules of disclosure, increased management accountability, enhanced role of the board of directors in shaping corporate strategy and positive changes in the practice of compensations. In addition, thorough preparation of board meetings and the introduction of risk management standards were mentioned.

At the same time, respondents from the intermediate group noted underdevelopment in Russian companies of the committee structure under the board of directors, foreign shareholders' lack of authority in terms of decision-making, scant regard for minority shareholder rights, and the absence or weakness of foreign influence in the appointment of senior executives, in the fields of environmental policy and corporate social responsibility, as well as in state companies in general.

Among responses to the question of influence of foreign shareholders we can make out another, fourth group, whose members are

Foreign investors bring new technologies and business models to Russian business. They are providing Russian companies with new competencies which help them to compete in global markets. They represent the main drivers of increased transparency of the Russian companies. (Senior manager of an international audit and consulting company)

of the opinion that **the impact on corporate governance in Russian companies in terms of convergence with international standards does not stem from foreign shareholders as such, but the financial markets in general**. Especially important is the role of international banks, whose extended services come hand in hand with strong recommendations along the lines of: "You should do it like this, not like that." It goes without saying that the listing of a Russian company on a foreign stock exchange is also of great importance – especially if the listing is in the U. S., where requirements for corporate governance are at their most stringent.

In the first part of the questionnaire were also included two closed questions. The first of these asked respondents **to rate on a 10-point scale the state of the legal and regulatory environment in Russia** in the following categories:

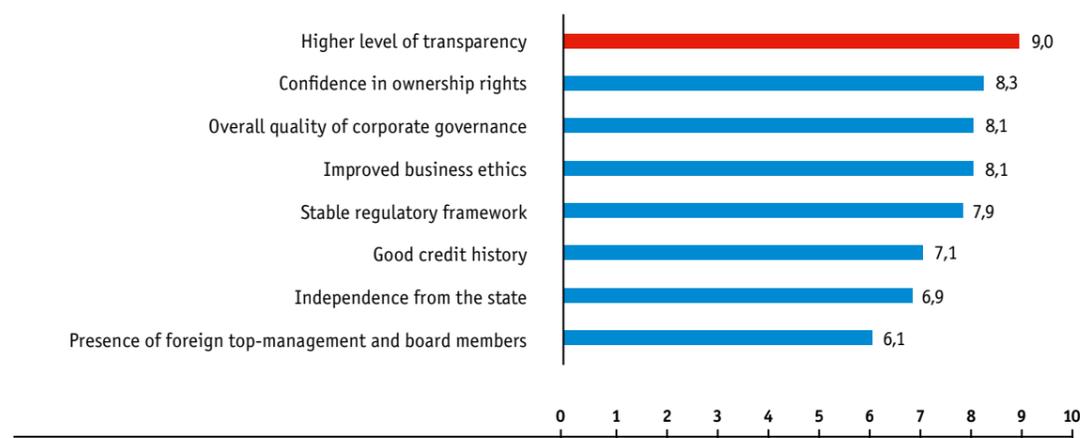
**Figure 1. Legal & regulatory framework factors influencing business environment in Russia**



starting a new business, obtaining licenses, protection of investor rights, law enforcement practice, dealing with tax authorities, information disclosure practices and the quality of interaction between business and state (Fig. 1). The average scores in all these categories were surprisingly similar: from 4.0 points (licenses) to 5.6 points (investor protection), and in five of the seven categories the average score was below 5.0. Judging by these results, foreign experts do not rate too highly the current state of Russia's legal environment and regulatory practices in relation to business. This once again emphasises the extreme relevance of the recent intensification of efforts by government authorities to improve the legal framework of corporate governance. The second closed question proposed *evaluation on a 10-point scale of the importance of several factors involved in increasing confidence in Russian companies within the in-*

*ternational investment community* (Fig. 2). It listed the following factors: confidence in property rights, a stable regulatory environment, the independence of the company from the state, good credit history, overall quality of corporate governance, a high level of transparency, commitment to business ethics, and the presence of foreigners among senior managers and board members. As could be expected, the importance of all these factors has been evaluated quite highly: the average scores were higher than 6.0. The surprise was that the lowest average score (6.1) pertained to the presence of foreigners in governing bodies. The most important factors for our experts turned out to be a high level of transparency (an average of 9.0 points), confidence in property rights (8.3 points), the overall quality of corporate governance and commitment to business ethics (8.1 points), i. e. universally essential factors – internal, rather than external.

**Figure 2. Factors which could strengthen and promote confidence towards Russian companies among the financial and investment community abroad**



## 2

## THE RELATIONSHIP BETWEEN THE GLOBAL FINANCIAL CRISIS AND CORPORATE GOVERNANCE

The second part of the study was devoted to ascertaining the views of foreign experts with regard to the impact of the global financial crisis on Russian business. The first in this series was an open question on *whether the greater scope of the crisis in Russia compared with other BRIC countries could be linked with the peculiarities of Russian corporate governance practices.*

In this case, the opinions expressed by our respondents were practically unanimous. The current state of domestic corporate governance can hardly be regarded as a good explanation for the particular scale of impact of the crisis in Russia. The depth of the crisis that hit the Russian economy is connected, first of all, with its high dependence on commodity exports and substantial external financing. Russia is still very dependent on the production of natural resources and has failed to create alternative sources of income. China and India, on the other hand, have a much more diversified economy based on manufacturing cheap goods. The problems faced by the Russian economy have been caused mainly by a significant reduction in global demand for commodities and trade flows, as well as the fact that it has become very difficult for Russian companies to postpone or restructure their debts to foreign creditors or to obtain financing for new projects.

Nevertheless, some experts expressed reservations related to the issue of corporate governance. For example, one remarked that "the risks perceived by foreign portfolio investors in connection with the imperfections of corporate governance in Russian companies probably prompted them, in a crisis situation, to withdraw their capital from the country." Another said that in some industries, the massive expansion of Russian capital on world markets was "irresponsible". A third drew attention

to the fact that many Russian companies had not developed adequate policies in relation to strategic risk, and were thus completely unprepared for the sudden economic downturn.

Also fairly unanimous was the response to the closed question: *"In which aspects of corporate governance at company level has the financial crisis revealed the most obvious weaknesses and shortcomings?"* (Fig. 3). Most respondents (71%) identified **the system of risk management; half – the role of the board of directors in reviewing and guiding corporate strategy.** The other possible answers (composition of the board of directors and qualifications of its members, insufficient requirements for expertise and qualifications of senior managers, accounting standards, regulatory requirements, ensuring the rights of minority shareholders and investors, compensation of board members and top management) were mentioned considerably less often.

Respondents' opinions on the question *"Have there been changes in corporate governance practices within Russian companies as a result of the crisis, and if so, what are they?"* proved to be the most varied. Even a single response quite often held conflicting assessments.

Most frequently noted were **negative changes.** It was pointed out that as a result of decreasing availability of foreign capital, attention to the reform of business practices in ac-

Many Russian companies had not developed adequate policies in relation to strategic risk, and thus were completely unprepared for the sudden economic downturn. (Senior manager of a foreign bank)

**Figure 3. Corporate governance shortcomings at companies' level revealed by the crisis (%)**



cordance with the best international standards weakens. As mentioned by one expert, "the fact that state-owned banks were virtually the only source of funding in emergency conditions dramatically increased the influence of the state on major private players, who were essentially forced to choose: either you meet the requirements of the state, or risk going bankrupt." According to another respondent, "corporate governance in Russia has taken a step backwards; with capital markets closed and survival on their minds, most companies simply forgot about internationally accepted governance standards, and got on with doing whatever was necessary to survive." A third expert was no less categorical: "The crisis has revealed the formal, declarative nature of many corporate governance procedures... There are a lot of examples when minority shareholders' interests are worth nothing for major shareholders. In some cases it reminded the Russian business culture of the 1990's."

Participants in the study noted that when facing cash shortages, company executives believe the cost of properly maintaining a system of corporate governance to be "superfluous, not dictated by necessity" or "excessive". In a number of companies the role of the board of directors was weakened, the latter being considered by majority shareholders as merely

a "necessary luxury" for companies that are listed or wish to be so. Some cases showed a deteriorating situation with regard to the observance of minority shareholders rights, manifested in particular in a tendency to hold less face-to-face meetings of the board of directors where current problems can be openly discussed, and to leave more issues to the discretion of senior management.

**During the crisis, corporate governance in Russia has taken a step backwards. With capital markets closed and survival on their minds, most companies simply forgot about internationally accepted governance standards, and got on with doing whatever was necessary to survive. (Senior manager of a major Russian bank)**

On the other hand, many experts noted **positive changes** in Russian corporate governance practices. It should be recognised, of course, that such assessments are often general in nature: "the desire to improve the quality of corporate governance has increased"; "companies have learnt their lesson and are trying to im-

prove corporate governance"; "there is a growing awareness of the importance of corporate governance". However, alongside these general observations was laid down concrete evidence of positive changes:

- The leadership of many companies has realised the need to implement appropriate systems of risk assessment, control mechanisms and rules for risk management;
  - There is now a clearly marked trend toward improving corporate governance in individual companies, for example, in terms of increasing transparency and enhancing corporate communications;
  - Increased attention is being given to controlling expenditure;
  - Companies are shedding the non-core investments and businesses that they could afford in pre-crisis times;
  - Boards of directors now get corporate information more rapidly, and in more detail;
  - Russian companies are increasing recruitment of foreign managers and board members.
- Several experts mentioned changes that are difficult to place as unambiguously positive or negative, appearing to be more **neutral in character**. Among them:
- A return by majority shareholders to stricter control over the company;
  - The introduction to the board of directors of people able to influence the position of federal or local officials;
  - A reduction in the remuneration of board members.

Finally, several respondents were of the opinion that there had been **no significant changes** to corporate governance practices in Russia as a result of the crisis. This position was most clearly expressed in the following response: "Since the start of the crisis there has been no wide debate on corporate governance practices in Russia in the post-crisis period, and, as a result, any noticeable adjustments by companies." There were, however, two foreign specialists working in Russian companies (a board member and a senior manager) who specially noted that their companies had made all the adjustments necessary in order to respond to the crisis in an appropriate manner.

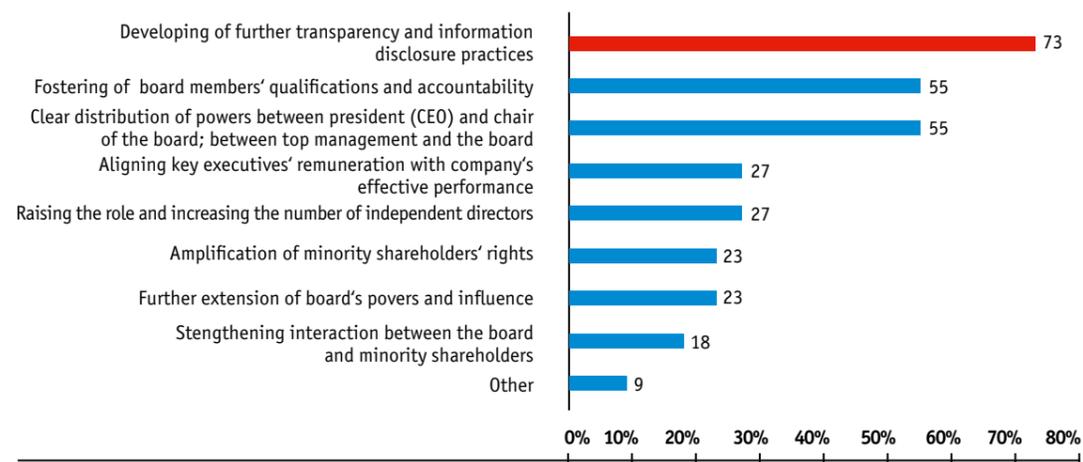
There were curious answers to the closed question "What aspects of best practice in corporate governance are most important for Russian companies today?" (Fig. 4). The most popular variant was "Developing of further transparency and information disclosure practices" – chosen by 73% of respondents. Two other possible answers – "Clear distribution of powers between the company CEO and chairman of the board, and between top management and the board" and "Fostering of board members' qualifications and accountability" – were selected by 55% of experts each. All other options – "Further extension of the board's powers and influence", "Raising the role and increasing the number of independent directors," "Strengthening interaction between the board of directors and minority shareholders", "Align-

**Since the start of the crisis there has been no wide debate on corporate governance practices in Russia in the post-crisis period, and, as a result, any noticeable adjustments by companies. (Member of the board of directors of a major Russian company)**

ing of executive directors' remuneration with the company's performance" and "Amplification of minority shareholders' rights" – attracted much less attention: they were picked out by 18–27% of respondents. From this we can conclude that for foreign shareholders and investors the most important thing now is a more complete understanding of the reality of the situation in Russian companies and the opportunities which the board of directors has to influence the situation.

In tandem with the development of the global financial crisis, which among other dramatic events saw several world-famous multinational companies and banks go bankrupt, **discussion regarding the need for reform in regulating corporate relations has become widespread**, in Russia as on an international level. In this regard, study participants were asked

**Figure 4. Aspects of corporate governance best practices of most significance to Russian companies today (%)**



the following open-ended question: *"In what way must the legal and regulatory framework of corporate relations change in Russia and in the West as a result of the crisis?"* The answers we obtained pointed out the inadequacy of the existing regulatory framework, first of all, as concerns enforcement practice. In particular, attention was paid to the fact that compliance with the existing norms is very formal, which inevitably entails all sorts of abuses and the inclination to create corporate governance tools with poor actual content. The need in public discussion of this problem was also emphasized: "We are not sure there is a clear straightforward answer to this question. There is definitely a need for a discussion" involving authorities and the key market participants. It makes sense to coordinate these discussions internationally, even though this process will not be simple and smooth.

One of the answers comprised the forecast of probable changes in regulation of corporate relations, whereby the capital adequacy requirements, regulation and assessment of financial institutions are likely to become more stringent. There is high probability of regular stress tests being introduced for the bank sector. Remuneration schemes at banks and in strategic sector companies will become more transparent and more long-term result-focused. No doubt,

these changes should be coordinated internationally because they will primarily influence global multinational companies.

Two experts made fairly detailed proposals as to the improvement of not only regulatory framework but also of the entire corporate governance practice, with the view of the lessons learnt from the crisis. One of them, a top manager of the multi-national company, believes that, firstly, the focus should be on improvement of the risk management system and the role of the board of directors in this process. Secondly, strict compliance with applicable law, law enforcement practices, adopted corporate by-laws and procedures should be turned into a cornerstone principle by regulatory authorities and companies. The business units in charge of supervision over compliance with corporate governance standards should be reinforced significantly. The internal audit service should be vested with greater powers and become more independent. Thirdly, there is a need to improve corporate directors' and corporate secretaries' qualifications. Fourthly, it is important to excel the management remuneration practice. Corporate losses related to unsubstantiated risks should influence the remuneration of managers who are obliged to bear the same losses as shareholders do. Fifthly, Russian regulators, first of all, the Ministry for Eco-

nomics Development and the Federal Financial Markets Service, are to take a more active part in all global initiatives on corporate governance harmonization and disclosure level upgrading. The other expert, a top manager of the Western law firm, believes that what Russia needs most is a stronger and more effective legal and regulatory environment, so that businessmen can rely on their ownership rights to assets, shares, etc. without fear of raids from government authorities of various levels, competitors and business sharks. There needs to be a change in business culture, and businessmen need to have an interest in the long term success of their businesses and their country. There is still too much of the post-Soviet "here today, maybe gone tomorrow" attitude. The same expert noted that in the West, the most critical need is for a better regulation of the banking and finance industries. Russia also needs to strengthen its banking and finance sector, but "in some ways regulation is much more effective here than in the West".

As noted above, most of the study participants think that the crisis suggested that the most vulnerable corporate governance element in Russian companies is **risk management**. With the risk problem being a critical item, special attention was paid to it in the questionnaire. In particular, a general closed question was asked: *"Are you satisfied by the way the Russian companies identify and manage potentially significant financial and non-financial risks?"* As should be expected, most respondents (50%) expressed their dissatisfaction, 43% selected the "partially satisfied" option, and just 7% were "fully satisfied".

In another, open question, we asked to name **risk types and risk management issues that are typical of Russian companies**. In answering this question, some experts shared more general problem assessments. One of them noted that Russian companies lack skills and experience in risk management and damage mitigation: "Everything was aimed at growth rather than prudential issues. Financial risk management was almost non-existent". On the contrary, another survey

participant believes that Russian companies identify financial risk, while underestimating identification and management of a wide range of other risks. According to the third expert's experience, Russian companies normally have risk maps, update and follow them; however, in practical sense all of these things are done too formally. The fourth respondent expressed the opinion that "risk models were built upon 10% changes in the business environment, but not on 75% changes that occurred during the crisis".

In their answers, the experts often named various specific risks and drawbacks of risk management as typical of Russian companies. The most significant of them are as follows:

- Corruption related risks;
- Legal risks due to the lack of clear-cut legal framework for entrepreneurial operations;
- Tax risks;
- Risks of governmental intervention;
- Practice of risky financial borrowings;
- Excessive reliance on short-term borrowing due to the absence of ruble lenders who provide funds for a long term, absence of adequate financial service instruments;
- Weak debt management; discrepancy between the burden of liabilities and available funding and, consequently, critical liquidity reduction, which leads to inability to fund business transactions on a continuous basis;
- Risks related to forex transactions;
- Lack of confidence in precision of financial statements and in real independence of the external auditor;
- Weakness of internal audit procedures;
- Imperfections of business partners' risk assessment;
- Lack of substantiation of asset value assessment, in particular, in M&As; overall under-development of professional assessment.

The risk problem in the crisis proved to be extremely acute not only in Russia but also in the West. What should be done to mitigate, if not eliminate, it? To analyze our experts' opinion on this issue, we posed the open question to them: *"Which adjustments should be made to the strategic management of Russian and foreign companies during a time of crisis?"*

The answers contained both general and more detailed proposals. The survey participants were unanimous in that in most cases corporate risk management strategies and policies should undergo substantial revision. The risk management system is to reflect greater market, in particular financial market, volatility. Risk identification and damage mitigation efforts should become more timely and efficient. Any risk management system fights a los-

**The increased role of the state is necessary because there has been no other source of liquidity. However, it is negative because it means that managers and owners must have as their first priority the possible government attitude toward or reaction to any major business decision. No one dares to make a major investment without going to the Kremlin (or the White House) to see if it is OK with the powers that be. (Member of the board of directors of a major Russian company)**

ing battle if it is built up only as a response to crisis. It should be preventive by nature and be available to management at any turns of the economic development. It is necessary to introduce clear-cut risk management rules and guidelines within the companies. There is a need in a structured risk management process, which identifies the key risks and outlines the efforts to be taken under different circumstances in future. It is necessary to ensure regular cash flow sensitivity analysis, in order to envisage coverage of debt payments. When each project is implemented, precise risk criteria should be elaborated, and their application should be monitored.

Besides, the respondents drew attention to the need in greater shareholders' supervision over the management's operations, improved control system that should be made precise and independent from corporate executive bodies. Two answers contained the proposal

as to introduction of the position of Chief Risk Officer (or Enterprise Risk Manager) who will track all risk types, including financial, operational and (which is most important for Russia) legal, regulatory and political ones. The person to hold this position must be directly accountable to both the company's CEO and the board of directors.

One of the answers contained a detailed proposal how to increase the role of the board of directors in risk management. The board of directors is to undertake responsibility for different risk management aspects, including risk assessment, risk map analysis, monitoring, and risk management strategy elaboration. It is advisable that, at least quarterly, the board of directors devotes a special meeting to analyzing principal risks the company faces and discusses the mitigation efforts taken by the management. In considering any strategic initiative, the board of directors must be sure that all possible risks are taken into account. There is a consensus of opinion among experts that, in establishing a risk management system, it would be helpful for domestic companies to use foreign specialists' experience. In any event, when asked *"In which particular areas are the capabilities and expertise of foreign top managers and directors most needed at present in Russian companies?"* "Monitoring and modification of risk management systems" was the most common response. The second and third most common answers were: "Expertise in international financial markets" and "Monitoring the effectiveness of the company's management".

However, the survey participants are rather skeptical about willingness of Russian owners and corporate CEOs to resort to foreign specialists for services. A relative majority, 41% of respondents, believes that *during the crisis the interest to attract and retain foreigners in boards and executive bodies of Russian companies* has decreased; 35% are sure that no changes have happened; and only 25% think that interest has increased. One expert specified that, in case of top managers, the crisis resulted in a greater willingness to hire and properly pay experienced talented foreign special-

ists; whereas the opposite is true in case of independent directors. "This is due to the fact that companies face the threats to their survival, and they urgently need the right people in the right places", he explained. "As concerns boards of directors, Russian companies are less motivated to "window dress" themselves using foreign independent directors. During crisis, internal reforms are not a priority for them".

Another subject that is actively discussed in connection with the global crisis is **a greatly increased role of the state in the economy** – not only as the regulator but also as a shareholder. The greater presence of the state in domestic companies' capital can't but influence corporate relations. In this connection, it is interesting to learn foreign experts' opinion as to *which way the state's increased role in Russian economy will influence the corporate governance system in Russian companies*. All respondents do believe that this factor will impact current corporate governance system; 75% are sure that it will negatively affect corporate governance.

The explanations given by certain experts to their answers are also interesting. For instance, one of them noted: "It entirely depends on what is done and how – state influence and control is not in and of itself harmful, it is just that in practice it tends to be a damaging influence because decisions are so open to political influence". Other respondents were more categorical in their judgments. In their opinion, the state's increased role in the Russian economy would adversely affect corporate governance because the state will have a conflict of the shareholder's and regulator's interests expressed in divergence between the governmental policy, on

the one hand, and goals and obligations of this particular business, on the other. In particular, the conflict between the social duties imposed by the authorities and the financial health and efficiency of the companies is highly probable. With a greater state presence in companies, a real threat of its exerting pressure to create unfair competition conditions also arises.

It was a member of the board of directors of a major Russian corporation who was the most categorical in his views: "The increased role of state is necessary because there has been no other source of liquidity. However, it is negative because it means that managers and owners must have as their first priority the possible government attitude toward or response to any major business decision. No one dares make a major investment without going to the Kremlin (or the White House) to see if it is OK with the powers that be. Also, increased government influence means increased opportunities for corruption and pressure to succumb to demands for improper payments or other actions which undermine corporate governance".

It was only the CEO of a multinational audit and consulting company who expressed moderate optimism. By referring to his company's experience in other countries, he said that the vector of the state influence depends on its position with respect to corporate governance in state-run companies. The most recent initiatives of the Russian Government in this field, first of all, inclusion of independent directors in boards of directors of state-owned enterprises, suggest that the state is interested in improving corporate governance quality in SOEs and aims at improving the entire corporate governance system.

# 3

## MAJOR PROBLEMS FACED BY FOREIGN INVESTORS AND SHAREHOLDERS IN DOING BUSINESS IN RUSSIA

In discussing the prospects for improving the investment environment in Russia, which could serve as a weighty factor for overcoming consequences of the global crisis, it is necessary to understand how foreign investors themselves assess the conditions for doing business in this country. For this purpose, we asked a general open question to the respondents: *“Which principal problems do foreign investors and shareholders face in Russia?”* The problems specified in the answers can be divided into three categories: 1) state regulation related problems, 2) economic environment related problems, 3) Russian corporate practice related problems.

Presently in Russia there is no confidence in the impartiality of the legal system. The most prominent court cases seem to suggest that the courts are used as tools by special interests including the government and individual government officials, powerful private sector players to advance their own agendas. (Member of the board of directors of a major Russian company)

### State regulation related problems

This category of problems prevailed in the answers we obtained. Experts noted the enormous influence of the state and the officials who in their actions are often guided by unclear motives and goals. They emphasized that recently the influence of authorities, first of all, tax and control services, licensing agencies, on doing business has increased drastically. Naturally that red tape inherent in so ramified officialdom and high corruption dissatisfy foreign businessmen.

It was mentioned in answers that Russian laws and regulations need further improvement to make obtaining permits from authorities a less complicated and time-consuming undertaking. Laws on property rights should be improved fundamentally to streamline the share and real estate acquisition procedures. Enforcement problems were not disregarded by experts. In their opinion, legal provisions are not often complied with; there are no enforcement efforts to implement the applicable laws protecting shareholders’ rights. Accounting and disclosure requirements are fulfilled lop-sidedly and sometimes dreadfully. None of the respondents answered in the affirmative to the specifying question: *“Do current accounting and disclosure requirements provide investors and shareholders of Russian companies with sufficient information?”*

Some experts paid attention to the deep-rooted drawbacks in the existing judicial system, first of all, lack of court independence. For instance, one of them noted: *“There is no confidence in the impartiality of the legal system. The most prominent court cases seem to suggest that the courts are used as tools by special interests including the government and individual government officials, powerful private sector players to advance their own agendas.”* In his opinion, *“the same can be said for tax authorities and environmental regulators both of which appear to be random in their enforcement actions and targets. They are used to apply pressure in order to get targets to submit to pressures that have little to do with taxes or the environment”*.

### Economic environment related problems

The survey participants referred to the following:

- Low productivity of Russian enterprises;
- High monopolism in the economy;
- Lack of tough barriers to market manipulation;
- Currency risks that cannot be sufficiently hedged.

### Russian corporate practice related problems

In this context, the topics frequently raised in the answers to the first question of the questionnaire, i. e. on the particular features of doing business in Russia, were mentioned. In particular, experts pointed out that many Russian companies allocate the role of ‘honorary guests’ to foreign shareholders and investors, while decision-making and monitoring are in hands of an influential majority shareholder. They drew attention to lack of protection of minority shareholders’ rights, the existing problems with transparency of financial statements, with identification of the controlling owner and affiliates. One of the experts worded this problem more generally: *“There tends to be a culture of secrecy in Russian business verging on paranoia. It is understandable how this was derived – fear of the state, fear of competitors, poor legal and regulatory environment and uncertain enforcement but it is very unhelpful to the conduct of constructive business. Russian business needs an environment in which businessmen are much less afraid”*.

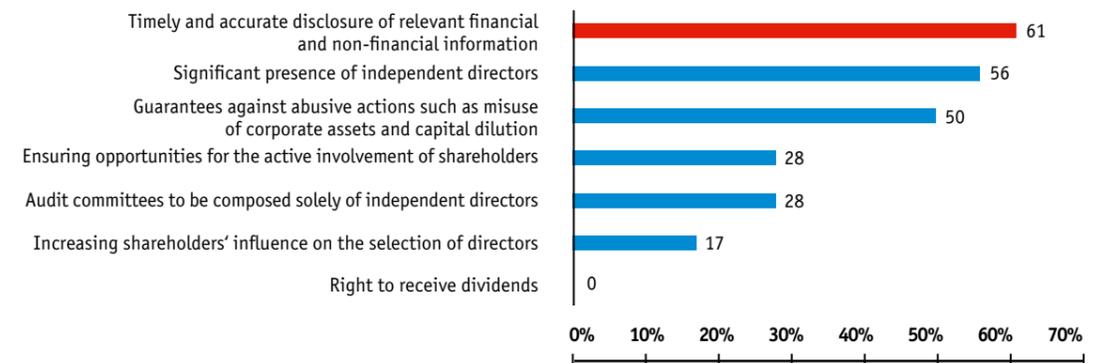
Most corporate governance experts support the opinion that infringement of minority shareholders’ interests in Russia, in particular during the crisis, is a fairly acute problem. In this connection, the following question was posed to respondents: *“Which of the mechanisms named below are the most helpful in protecting foreign minority shareholders’ rights in Russian companies?”* (Fig. 5).

Three response options apparently appeared to be the most frequent: *“Timely and accurate disclosure of relevant financial and non-financial information”* (61% of respondents), *“Significant presence of independent directors”* (56%) and *“Guarantees against abusive actions such as misuse of corporate assets and capital dilution”* (50%). Such mechanisms as the *“Audit committees to be composed solely of independent directors”* and *“Increasing shareholders’ influence on the selection of directors”* were mentioned by much less respondents, and nobody selected *“Right to receive dividends”*.

The survey participants were also offered to answer the open question on *the ways and mechanisms to improve communications with foreign shareholders and investors*, which could have been used by Russian companies. Our experts’ proposals proved to be very specific and diverse. Among available practical mechanisms, they named:

- Regular (twice a year) face-to-face meetings between top management and shareholders and investors;
- Publication of quarterly reports on corporate performance;
- Annual or semi-annual investors’ meetings;
- Arranging for shareholders’ visits to enterprises;

Figure 5. Mechanisms considered most helpful in protecting foreign minority shareholders’ rights in Russian companies (%)



- Attendance of corporate management at conferences arranged by the investment community;
- Information to foreign shareholders and investors on significant changes in Russian law, in particular those pertaining to statements and taxation;
- More frequent issue of news releases and clear-cut coordination of PR activities to avoid contradictory messages;
- Drafting of special training programs and courses for Russian investor relations specialists.

Notably, the two respondents' answers contain recommendations as to foreign partners, rather than as to the Russian companies' management. One of them suggests that regular meetings should be held between foreign independent directors and key minority investors or investor groups. The other believes that "to succeed in doing business in Russia, foreign shareholders and investors should learn to speak Russian and immerse themselves in Russian culture rather than expect the Russians to come to them".

## 4

## WORK OF THE BOARD OF DIRECTORS AND INDEPENDENT DIRECTORS IN THE CRISIS ENVIRONMENT

In the last questionnaire section, an attempt was made at obtaining a glimmering on how foreign experts assess the modern trends in activities of the most critical corporate governance institute, the board of directors, and the independent directors' position in it.

First of all, survey participants were asked: **"What particular changes have happened or are happening during the crisis in interaction between management and board of directors in Russian companies?"** The answers proved to be rather illustrative. A half of respondents believe that "No changes have happened". The answer "Role and position of the CEO and top management have strengthened to the detriment of the board of directors" proved to be somewhat less popular. It was only two respondents who noted that "Role of the board has increased, it has extra powers to run business" (one of them selected both mutually exclusive answers: in his opinion, the situation was different from company to company).

However, our experts seemed not to shape a fully clear view of the dynamics of the board's role, because when asked specifically: **"If role of the board has increased, please, specify the areas where this has happened?"**, not two of the above respondents, but several other ones, answered the question. Half of them selected the answer "Strategic planning", and nobody selected the answer "Protection of minority shareholders' rights".

With the risk management problem having become much more critical, the experts were also asked: **"Should boards of Russian companies be required to have a minimum number of members with financial or risk management qualifications even at the cost of fewer independent directors?"** Exactly 50% respondents agreed with this standpoint, 29% disagreed, whereas 21%

respondents were not sure. Therefore, a half of inquired experts is sure that knowledge and professional experience of a member of the board of directors is more important than his/her formal status.

As for the independent directors' position itself, the respondents were asked: **"Which kinds of problems remain topical in the day-to-day interaction of independent directors and management?"** Most respondents (57%) pointed out that "Independent directors' freedom of actions is limited by informal dependence on key shareholders and owners"; 29% respondents noted "Limited access of independent directors to corporate information", 21% respondents believed that "Management does not table on the boards' agenda certain key issues". A number of respondents additionally mentioned "delays with obtaining information and its frequently formal nature", and also that "independent directors are entitled to agree or disagree with a ready-made solution; however, they are devoid of the opportunity of full-fledged participation in decision-making".

However, certain experts believe that not only management is always to blame for the non-settlement of the above problems. In particular, it was noted that many foreign independent directors were not hard-driving enough towards the management. Foreign directors should lead changes in Russian companies, meanwhile they do not often fulfill this role.

In answering to the next question that is closely connected with the previous one: **"What, in your opinion, hinders the effectiveness of foreign independent directors in Russian companies?"**, the survey participants most frequently selected "Insufficient knowledge of Russian realities". Among other an-

swers, they also noted: "Lack of powers within the board", "Lack of powers of the board as a whole" and "Lack of information provided by management". It was one respondent only who pointed to "Insufficient motivation". Also, one expert only believes that "there are no major hindrances" on this way.

The questionnaire included two questions on independent directors pertaining to the respondents' personal experience. We asked foreign members of board of directors of Russian companies to rate "**freedom to express directly to management your initiatives and concerns**". 70% respondents believe that freedom is **very high**, 20% respondents, that it is **high**, and only 10% **are dissatisfied with** their opportunities in this respect.

In the same group of experts, a question was posed: "**While voting in the board on major corporate governance issues, how often you vote AGAINST the measures proposed by management?**" 90% members of boards of directors answered: **seldom**, and 10% said, **never**. Several respondents explained that they rarely vote **against** directly at the meetings of the board of directors because resolutions are usually agreed upon before voting; differences are normally closed on by negotiations at the stages of ad hoc committees. According to one of them, "issues are not put to vote until it becomes clear that consensus has been reached; if there are major differences, the issue is normally taken off the agenda or is postponed, so that to modify the resolution or to convince the discordant members that it is acceptable". If foreign members of board of directors ever vote **against**, it is largely on compliance with minority shareholders' rights.

Therefore, **foreign members of boards of directors who took part in our survey regard the corporate governance practice in their company much more positively than the practice typical of the entire Russian corporate community**. Possibly, the loyalty to their company and also the fact that immediate personal experience outweighs the influence of stereotypical ideas manifest themselves here.

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The survey results allow making several conclusions.

Firstly, the set of serious problems raised by foreign specialists in their answers, the list of gaps in Russian corporate governance generally coincide with a range of topical problems discussed in the domestic expert community, in particular those discussed in the first and second issues of the National Corporate Governance Report. For understandable reasons, the keynotes of discussion differ: greater categoricity and criticality of judgments are typical of many of its foreign participants. Besides, they are more focused on the importance of the risk management mechanisms in the corporate governance system and the need to ensure the minority shareholders' rights.

Secondly, the opinions of foreign specialists closely connected with the Russian business did not fully coincide. Differences in their opinions are especially significant in the overall assessment of the practice of doing business and the management culture in Russia, as well as the degree of influence produced by foreign shareholders and investors on corporate governance in Russian companies. At the same time, it is noteworthy that extreme positions, such as total criticism and an extremely positive attitude to the Russian reality, are shared by the minority. Both the progress achieved in the recent decade and the existing drawbacks are evident to the bulk of foreign businessmen and experts covered by the survey.

Thirdly, a number of typical features in the domestic practice of doing business (centralization of managerial functions, hypertrophy of personal factors in business culture, unequal attitude to different groups of shareholders, lack of transparency of deals with subsidiaries etc.), which cause our experts' negative judgments, are due to concentration of control by one or a group of majority shareholders in most Russian companies. Therefore, it is hardly realistic to anticipate quick and radical changes in this area. However, the perceived corporate governance regress, rejection of ear-

lier achieved standards, even though they are caused by the tough crisis environment, necessitate close attention and response on the part of the key shareholders and senior executives of Russian companies. Otherwise, the possibilities of raising capital externally, which gradually appear as global financial markets stabilize, will prove hardly realizable for them. The same applies to the need for establishing clear-cut risk management mechanisms as an element of the corporate governance system, to which foreign experts attach primary significance.

Last but not the least. In answering to questions with different content, our experts constantly emphasized the importance of improving Russian companies' transparency, even though they admitted some progress achieved in this area in the recent years. Obviously, the focus on this problem is quite justified: under the tougher conditions, a strategic investor should clearly understand where he invests his capital in. In their turn, top managers of Russian companies should take into account this circumstance.



## ABOUT NCCG

**The National Council on Corporate Governance** was established in March 2003 at the initiative of the RF Government and with support of business community.

Initially, NCCG operated as a public consultative forum of CEOs and Board chairpersons of the largest Russian issuer companies and investment funds, heads of the federal authorities and MPs of relevant committees of the RF State Duma and the Federation Council.

As of December 2004, the NCCG was re-launched as a non-profit partnership, whose founders include the RF Chamber of Commerce and Industry, the Russian Union of Industrialists and Entrepreneurs, the Association of Russian Banks, OPORTA Rossii (Russian Small and Mid-Size Entrepreneurs Association), and the Business Russia Association. The NCCG Chairman is **Vladimir O. Potanin**, President of Interros Company. The NCCG key objectives are to promote investment attractiveness of the national economy as well as to enhance image and reputation of the domestic business community through further development of the corporate legislation, sharing best practices and improvement of corporate governance standards.

### **The NCCG core activities include:**

- Promotion of domestic corporate legislation and corporate governance best practices;
- Facilitation of expert research of high quality and integrity in the sphere of corporate governance;
- Systematization, analysis and targeted dissemination of information on corporate governance developments both in the RF and abroad;
- Fostering further development of the professional community;

- Interaction and cooperation with relevant Russian and foreign organizations and the investor community.

The National Council on Corporate Governance hosts conferences, round table sessions, seminars and information exchange meetings, provides coordination for resourceful dialogue and experience sharing between the business community and the government agencies.

Once in four years the NCCG holds its major international event – a high profile international conference on topical issues of corporate governance and investment opportunities in Russia. The First NCCG International Conference "Corporate Governance and Economic Growth in Russia" took place in June 2004; the Second Conference "Corporate Governance and Globalization of the World Economy" was held on 30–31 May, 2008 in Moscow.

Since 2008 the NCCG publishes annual "National Corporate Governance Report", which provides a comprehensive overview of current situation with major aspects of corporate governance in Russia and key developments in companies' practices and law enforcement.

The NCCG web-site is [www.nccg.ru](http://www.nccg.ru)



## ABOUT RBCC

### **The Russo-British Chamber of Commerce**

Ever since its foundation in 1916, the Russo-British Chamber of Commerce has served as the bridge between Russian and British business. From pre-revolutionary times, throughout the Soviet period and Russia's subsequent transition to a market economy, the RBCC has consistently supported its Russian, British and multinational member companies in building trade, cooperation and understanding. As an independent, bilateral organisation, the RBCC occupies a unique place in the history of UK-Russia relations, providing practical assistance to companies from both countries looking to access new markets.

In 2010, as the world economy adjusts to new market conditions, the RBCC's mission is more relevant than ever. Headquartered in London, and with offices in Moscow and St Petersburg, the Chamber is uniquely placed to represent the interests of its member companies across all industry sectors, from sole traders and SMEs to multinational corporations. All three offices run regular programmes of seminars, networking evenings, conferences and trade missions, to which all Chamber members have equal access.

Whether you are long established in Russia or the UK, or entering a new market for the first time, the RBCC's bilingual staff are ready to provide up-to-the-minute business advice and give assistance in finding reliable, long-term business partners. Working closely alongside both the UK and Russian governments, the RBCC promotes the interests of its members at the highest level.

The RBCC web-site is [www.rbcc.com](http://www.rbcc.com)

