Chapter II

ONGOING ISSUES IN RUSSIAN CORPORATE GOVERNANCE

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Twelve years ago, my colleague Michael Heller and I published *Corporate Governance Lessons from Russian Fiascoes,*[2] an article whose title reflected the then uniformly bleak state of affairs. Since that time surveys suggest that substantial progress has been made, at least in terms of "law on the books", but that much remains to be done.[3]

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2 Merritt B. Fox & Michael E. Heller, Corporate Governance Lessons from Russian Enterprise Fiascoes, 75 NEW YORK UNIVERSITY LAW REVIEW, 1720 (2000).

3 By the middle of the last decade, there were rays of hope. See, e.g., The National Council on Corporate Governance, Corporate Governance and Economic Growth in Russia (2004) (hereinafter, "2004 Survey"); Sergei A. Porshakov, Recent Corporate Governance Trends in Major Russian Companies, 1 Corporate Governance in Russia and Transitional Economies (2005). Subsequent assessments suggest further progress, but still a situation far short of ideal. See Olga Lazareva, Andrei Rachinsky & Sergey Stepanov. A Survey of Corporate Governance in Russia <papers.cfm?abstract_id=997965>* /CEFIR/ NES Working Paper No. 103/ (2007); John Bowker, Russia Held Back by Corporate Governance

The range issues that remain is much too broad for them all to be discussed in a serious way in a short comment such as this. Instead, the author will make brief remarks about five particularly important ones: whether state controlled enterprises ("SOEs") should be subject to the same governance regime as purely private enterprises, disclosure of beneficial ownership, dividends, enforcement of financial and business disclosure requirements, and the role of non-shareholder stakeholders and their interests in corporate governance.

2.1. Separating the corporate governance debate concerning SOEs versus others

About one third of Russia's largest corporations are controlled by the national government through direct or indirect share ownership.[1] Much of the discussion concerning Russian corporate governance concerns these firms.[2] The author will suggest here that the corporate governance issues that these SOEs present are sufficiently different from those presented by other Russian firms that an analysis that does not separate the two kinds of corporations seriously distorts the discussion of what is best with respect to the non-SOE firms.[3] Clarity with respect to what is best for non-SOE firms is important. Non-SOEs represent 60%

Weakness: Fund, Reuters, September 10, 2010, available at http://www.reuters.com/article/2010/09/10/us-russia-investors-idUSTRE6893BO20100910; R. Pathak, Corporate Governance in Russia: A Report (2011), available on SSRN<papers.cfm?abstract_id=1782684>.

1 Standard & Poor's, Transparency and Disclosure by Russian Companies 2010 (2010) 13 (30 out of the 90 largest stock exchange listed Russian companies).

2 For an excellent overview of the government role in operation of Russian SOEs, the extent and pattern of government ownership and trends over time, and the primary governance issues associated with Russian SOEs, see Carsten Sprenger, State Ownership in the Russian Economy: Its Magnitude, Structure and Governance Problems http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1311223 (2010).

3 For an example of scholars who believe that the substantial role of the government in many Russian corporations calls for a different model for all Russian firms, see O. Lazareva et al, supra note 2.

of the capitalization of Russian stock markets.[1] And they are likely to be the predominant origin of innovation that will drive Russian economic growth as oil, gas and mineral extraction as sources of growth inevitably run their course.

2.1.1. The Meaning of Corporate Governance

Corporate governance concerns the design of decision-making structures relating to a firm's choice of new investment projects and its operation of its existing ones. The appropriate focus here is on the factors that influence the decisions at the top of a corporation. Internal controls beyond those applied to the directors and top managers, important as they are for a well-functioning corporation, do not involve issues of corporate governance. Rather they are part of the tools of good administration needed by any organization, whether a government ministry, a for-profit corporation or a non-profit organization, to assure that the organization as a whole behaves in accordance with the decisions and goals of top management.

Normatively assessing a firm's corporate governance involves two considerations. One is the effectiveness of the firm as a creator of value: its capacity give back to society resources of greater value than what it takes from society. The other is the fairness with which the firm treats those who have to deal with it on a longer term basis, including non-control equity shareholders.

2.1.2. The Importance of the Reasons for Government Control of SOEs

In assessing the effectiveness of the corporate governance of the large Russian SOE as creators of value, it is important to focus on why, in the first place, the government possesses control amounts of the shares of these firms. For the typical Russian SOE, the government's share holdings do not reflect an inability of the SOE to mobilize new capital in some other way besides a sale of shares to the state. This very different than, for example, the situation with the US government's controlling interests in General Motors or AIG, where the government was the financier of last resort and obtained control simply as an incident

1 C. Sprenger, supra note 4, at 10.

of providing essential financing. The Russian government retained, or obtained, control of the SOEs as an end in itself. The government has suggested that the aims in furtherance of which this control is being held include national defense, regulation of natural monopolies, provision of adequate supplies of goods despite regulated prices, the protection of cultural values, the provision of intrastructure that provides externalities, and the coordination of economic development.[1] The trend has been toward SOEs of larger size in strategic sectors and ones deemed important for industrial development, and away from smaller firms and other sectors.[2]

If there is a legitimate purpose to the state possession of control for its own sake, it reflects the view that government control can be used in a way that increases such a firm's net contribution to society relative to what would be expected if the shares were in private hands. This is a very important observation. It means that corporate governance has not failed just because the firm does different things than a well functioning firm whose shareholders were all private. Indeed, inducing this difference in firm behavior is the whole point of government control.

The belief that government control of a firm is needed to foster its net value contribution to society implicitly rests on a theory of market failure of some kind that cannot be effectively corrected by regulation. In other words, the firm is thought to pay less for the resources that it uses than at the margin is their value to society and/or to be paid less for its output than at the margin is its value to society. These miscues in pricing would lead to behavior, if the firm were entirely in private hands that would deviate from what would provide the greatest net contribution to society. And this deviation is thought to be more effectively and efficiently correctable through direct government control than through regulation, taxes and subsidies.

1 Id. at 16.

2 Id. at 15.

2.1.3. The Important Public Policy Issues Raised by SOEs

Viewed from this perspective, SOEs raise two important issue of public policy. First, with respect to any given SOE, are the beliefs set out above correct. Is it as a practical matter possible for government control of the SOE to be used to operate it in a way that would contribute more to society than the way that it would be run owned entirely by private shareholders? Second, even it if is possible, are the agents of the government exercising this control doing so in the desired fashion. These are the issues that animate debate in Russia today concerning SOEs. The first goes to the question of the size of the government in the economy: should the government be selling its control shares in many or all of the SOEs or should it maintain its current holdings.[1] The second goes to question of whether there are directors representing the government on SOE boards that need replacement because they were appointed as a result of cronyism or corruption within the political system, and they are making incompetent or self-interested decisions

1 Prime Minister Vladimir Putin, for example, recently said "the share of the state in the Russian economy… remains rather high" and advocated privatizing key assets for "structural" reasons so as to "boost the competitiveness of our economy and clear the way for the private initiative." Vladimir Putin, Russia Needs More Technology and Less Corrupton, http://blogs.ft.com/beyond-brics/2012/01/30/guest-post-by-vladimir-putin-russia-needs-more-technology-and-less-corruption/#axzz1mgTTh6HG (2011). In the mid 2000s, however, during Putin's presidency the share of the state actually increased from approximately 30% to 35%. Piotr Kozarzewski, Corporate Governance Formation in Poland, Kyrgyzstan, Russia, and Ukraine <papers.cfm?abstract_id=1016064>*/Studies and Analyses No. 347 (2007). Whatever share the state does retain, it appears that government wishes to keep a strong voice in directing the affairs of SOEs. First Deputy Prime Minister Igor Shuvalov stated that government appointees will be "professional trustees" and defined the term by saying "an independent director acts in line with his vision of what is best for the company's development while a professional trustee acts on the government's orders." Denis Dyomkin, Russian Government Says Will Keep Clout on Company Boards, http://in.reuters.com/article/2011/04/22/idINIndia-56524620110422 (2011).

that are inconsistent with goals that justify government control in the first place.[1]

2.1.4. Difference From the Important Policy Issues Involving Non-SOEs

Neither of these important policy issues relating to SOEs has much in common the corporate governance problems faced by Russian corporations that are fully privately owned. The first issue relating to SOEs concerns how well markets external to the firm function in terms of the prices of goods, services and resources, and to the relative capacities of government to correct for market failures externally, through regulation, taxes and subsidies versus internally through the exercise of control. The second issue concerns the day-to-day functioning of the political system. In contrast, the corporate governance problems facing non-SOE firms relate to the rules by which its basic constituents – in particular its suppliers of managerial skills, capital and labor – relate to and among each other.

It might be argued that the SOEs and non-SOEs nevertheless raise similar issues with respect to the fairness with which the firm treats those who have to deal with it on a longer term basis, which is also a normative issue in corporate governance. Fairness, though, relates to whether the issuer's behavior meets the legitimate expectations of these other parties. Non-control shareholders of SOEs are on warning that for reasons authoritatively determined by the state, the issuer will be run in a fashion that may not be in their best interests. It should not be a surprise to these shareholders when this in fact happens and any expectations on their part that it would not happen cannot really be said to be legitimate. Admittedly, when directors who are appointed by the government as a result of cronyism or corruption make incompetent or self-interested decisions, the resulting corporate

1 President Dmitry Medvedev, for example, in calling for the replacement of government ministers on many SOE boards stated that they must be replaced by persons who were "impartial, uncorrupted." Dyomkin, supra note [4]. Asa general matter, directors representing the government on SOE boards are reported to be chosen by highly informal and nontransparent procedures. C. Sprenger, supra note 4, at 17.

behavior is not the product of authoritative determinations of the state. Still these shareholders may not be genuinely surprised and again the failure is really one of the governmental political process, with the shareholders merely suffering "collateral damage."

With respect to a firm that the government has decided to privatize, it may be worthwhile for the government to try to replicate what would be good corporate governance for a non-SOE, but this is simply a transitional policy reflecting the government's desire to receive a good price at the time of sale and its abandonment of a belief that control to change the behavior of the corporation from what it would be in private hands is socially desirable.

Because of these fundamental differences between the policy issues raised by SOEs and those raised by non-SOEs, the remainder of this chapter will focus on the latter.

2.2. Disclosure of beneficial ownership and interested party transactions

The difficulties in knowing who are the beneficial owners of a firm's shares and how the shares have been voted are close to being the root of all evil in Russian corporate governance. Think of the worst things that have happened in the Russian corporate economy over the last twenty years: asset stripping, tunneling, and the squeezing out of minority shareholders for little or no compensation by various means such as dilution or sham bankruptcy.[1] All of these unfortunate events have involved "interested transactions." Interested transactions are ones in which a benefit is derived by an insider, i.e. a director, a high-level manager, or a shareholder who has enough power,

1 2004 Survey, supra note 2, at 13, 18, 37–39. The extent of problem is illustrated by a study of just one of the many methods that persons with control used to divert funds to them: "spaceman" transactions with short-lived special purpose entities beneficially owned by a corporation's insiders. Maxim Mironov found through a survey of 236 million banking transactions that diversions using spacemen aggregated an amount equal to 11.3% of GDP in 2003 and 13.1% of Russian GDP in 2004. Maxim Mironov. Cash Flow Diversion and Corporate Governance: Evidence from Russia 28–28 (2009) <papers.cfm?abstract_id=1357730>.

alone or in conjunction with a group of other shareholders, to influence corporate action. If, as is often the case, the terms of the transaction are less favorable to the corporation than would be the terms of a comparable arms-length transaction, the benefit received by the interested insider will come at the expense of the rest of the corporation's shareholders. No method can work for combating interested transactions to which a publicly traded corporation is a party on unsatisfactory terms without an effective means of disclosing the identity of the beneficial owners of control amount of the corporation's shares and of those who have a significant beneficial interest in the other party to the transaction.

2.2.1. Treatment of Interested Transactions Under Russian Corporate Law

The Russian Federal Law On Joint Stock Companies ("JSC") as originally adopted in the mid-1990s appeared to have had a means for dealing with interested transactions. The draftsmen understood that Russia would for some time have a weak judicial system and that its judges would be inexperienced in matters of business and capital[1] Russian courts, unlike the courts in a jurisdiction such as Delaware, would not be up to the complicated task of separating out those interested transactions that benefit the corporation as a whole from those that enrich the insiders at the expense of everyone else. The legislation therefore required that interested transactions be approved by a majority (for very large transactions, a supermajority) vote of disinterested directors and/or shareholders.[2] The assumption was that these disinterested parties would reject transactions involving terms that they were not convinced were as good as would have been found in a comparable arms-length transaction. Where these special procedures were not

1 See Bernard Black & Reinier Kraakman, A Self-Enforcing Model of Corporate Law, 109 HARVARD LAW REVIEW, 1911, 1914 (1996).

2 Federal Law on Joint Stock Companies, Federal Law No. 208-FZ, art.78–83 (Russ.). See also B. Black & R. Kraakman,supra note 12, at 1916–17. The procedures in these Articles were somewhat tightened in an amendment that become effective in 2002. Federal Law No. 120-FZ.

followed, an objecting outside shareholder would merely need to demonstrate to the court the absence of proper approval to void the deal. Determining whether approval was proper was assumed to be much easier for a court to adjudicate than determining whether the transaction was fair.[1]

2.2.2. Interested Transactions in Practice and the Problem of Disclosure of Interest

This approach has not worked as well as was hoped. There has been a long history of the beneficial ownership of shares in Russian corporations being unknown, or at least not known definitively enough to provide legally sufficient evidence in court. At least until very recently no Russian corporations even had a legal obligation to provide this information.[2] As a result, it has been hard for an objecting shareholder to establish critical elements of her

1 B. Black & R. Kraakman, supra note 12, at 1916.

2 S. Porshakov, writing in 2006, after reporting that recently a handful of issuers made available information on their beneficial owners, states that such disclosure is the "rather rare exception from the general rule, since the majority of Russian companies are still non-transparent." Porshakov, supra note 2 at 8. The 2004 Survey reports that even the record owners of large blocks of shares are hard for an outsider to determine. Until recently, the formal rules required an issuer only to report to the Russian securities authorities (the FFMS) the record holders of blocks in excess of 20% of its outstanding shares. Compliance with even this modest rule is low since there were no penalties for non-compliance. Moreover, the FFMS was not required to disclose to the public any information that it does receive. 2004 Survey, supra note 2, at 50–51. As for beneficial ownership, until recently there was no rule requiring disclosure even to the FFMS. Id. at 50. This non-transparency in the structure of ownership has been at the top of the list of investor concerns with Russian corporate governance. Id. at 80. It may have been possible through hard work to get a picture a Russian issuer=s beneficial ownership structure. A presentation made by VostokNatfa Investments Ltd at the OECD Corporate Governance Roundtable in Moscow on November 12, 2004 reflects this view: "The existing Russian disclosure can be combined with GAAP accounts, international company searches and press statements to build up a fairly accurate picture of ultimate ownership. However, this exercise requires time, money and effort." Because this information could only be obtained at substantial cost rather than by easy reference to officially filed documents, shareholder monitoring of compliance with the provisions that are supposed to protect against interested transactions has been deterred. Moreover it is not clear that the information obtained in such a search would be admissible in court.

case. A person who has substantial undisclosed beneficial ownership of an issuer's shares can hide the fact that he is an insider with influence over the issuer's decisions. Alternatively, or in addition, an insider of the issuer who has an undisclosed beneficial ownership of shares in the party on the other side of the transaction (or in an entity related to the party on the other side) can hide this fact and hence his interest in the transaction. Even where an insider's interest in a transaction is acknowledged and the corporation goes through the formal independent shareholder approval process, the insider can frustrate the process by having the shares that she beneficially owns voted in favor of the transaction and falsely counted as ones that are held by independent shareholders. She can engage in this deception because insiders control the counting of the votes and it has often been impossible even for outsiders to determine the identity of the owners of the shares that were voted in favor of the transaction.[1]

2.2.3. Legal Reforms Not Related to Disclosure

A number of the legal reforms unrelated to beneficial ownership disclosure have been undertaken since the original adoption of Law on JSC that are aimed at preventing one kind of bad transaction or other, such as dilutions arising from low-priced share offerings made only to insiders.[2] In large measure, these reforms represent patchwork solutions, however. They may be helpful, but they are not a complete cure. As long as there is no credible way of knowing who are the beneficial owners of Russian company shares, there is no effective way of stopping any type of interested transaction that is not specifically banned. When any one type of interested transaction is banned, ingenious insiders simply develop new ways of advantaging themselves at the expense of the other shareholders.

1 These problems are discussed in more detail in M. Fox & M. Heller, supra note 1, at 1764–65.

2 2004 Survey, supra note 2, at 13, 39–41.

2.2.4. The Need for Beneficial Ownership Disclosure Reforms

The more complete solution is a set of rules, backed by reliably applied stiff sanctions, requiring disclosure of all situations where a person, by himself or as a member of a coordinated group, is the beneficial owner of sufficient shares to be able to influence corporate action. A 2005 OECD White Paper on related party transactions in Russia recommended the adoption of rules requiring an issuer to disclose its significant beneficial owners.[1] An October 2010 amendment to the Securities Market Law, requiring issuers listed on a stock market to disclose beneficial owners of as little as 5% of the issuers shares, appears to be an effort to implement this recommendation.[2]

An effective disclosure regime, however, needs to be imposed not just on the issuer, but on the beneficial owners themselves. The issuer may not know who the significant beneficial owners are. And even if the issuer does, it can be hard for an enforcer or private party to prove that the issuer knew who the beneficial owners were in a case where the firm fails to disclose them.

The obligation imposed on the beneficial owners would need to include ones whose individual holdings alone are too small on their own to influence corporate decisions but who gain such influence by being a member of a coordinated group of holders. The October 2010 amendment to the Securities Market Law appears to go

1 OECD Policy Options Paper: Improving Transparency of Related Party Transactions in Russia (April 2005).

2 Federal Law No. 264-FZ (dated October 4, 2010) (Russ.), amending Federal Law on the Securities Market (Federal Law No. 39-FZ (dated April 22, 1996)). It is unclear how effective this legislation has been, however. A 2010 UNCTAD survey, while reporting this legislative change, nevertheless concludes that “many Russian companies do not name their beneficial owners.” UNCTAD Working Group of Experts on International Standards of Accounting and Reporting, Corporate Governance Disclosure in the Russian Federation (2011) at 9, 21. Available at http://www.unctad.org/sections/wcmu/docs/ciiisar_28th_BelikovPaper_en.pdf. A Standard & Poor's survey of the 90 largest publicly traded Russian firms found that for 2010, 30 disclosed all beneficial owners with more than 10% of the outstanding voting shares and 46 reported a beneficial owner holding more than 75% of the outstanding voting shares. Standard & Poor's, supra note 3, at 11.

a long way, at least in terms of law on the books, to accomplishing this result. Persons who are the registered owners of 5% or more of the voting shares are obliged to disclose information about any person controlling the registered shareholder and persons owning or controlling jointly with others more than 5% of the voting stock must report changes in their positions. Experience with Section 13 (d) of the US Securities Exchange Act of 1934, requiring 5% and greater beneficial owners to disclose this fact, and the SEC rules and case law that have developed around it, show, however, that it is a complicated task requiring some time to develop a set of authoritative interpretations that effectively impose disclosure obligations on such smaller beneficial owners that form a control group that in aggregate meets the statutory threshold.[1]

Finally, for the procedures in the Law on JSC intended to protect the corporation against interested transactions on unfavorable terms to work, individuals and entities that have been identified as having control amounts of beneficial ownership need to be required by the corporation law to disclose to the corporation whether they also have a beneficial interest in the other party to any transaction into which the corporation enters.

2.3. Dividends

Many Russian firms with positive earnings pay no dividends.[2] For those that do, there is a widespread perception among investors that the dividends are not

1 Louis Loss, Joel Seligman & Troy Paredes, Fundamentals of Securities Regulation 607–624 (6th ed. 2011).

2 There is evidence that recently Russian corporations are paying more in dividends, reportedly, in part due to the urging of President Dmitry Medvedev. Sophia Greene, Takeovers Full of Eastern European Promise, Financial Times, January 29, 2012, available at http://www.ft.com/intl/cms/s/0/b0a4879a-4803-11e1-b1b4-00144feabdc0.html#axzz1n2KzSzVt. Tax laws have also been changed so that corporate income from dividends paid by other companies is no longer taxable. Tax Code 275 and 284 (Russ.) The Ministry of Economic Development has called as well for a reduction in corporate income taxes for the portion of profits paid out as dividends. O. Lazareva et al, supra note 2, at 39.

in reasonable proportion to earnings.[1] The fact that the thinness of trading in the shares of many Russian issuers reduces the exit-through-sale option for anyone but the smallest holders is probably both a partial explanation of the paucity of dividends and a reason for special concern.

2.3.1. Proposals for Mandatory Dividends

There have been calls from time to time, including proposals by State Duma deputies, that would require Russian corporations to pay out as dividends a certain percentage of each year's earnings.[2] These proposals have historical precedent in 19th century US corporate law.[3] The US laws were abandoned long ago and instead the directors of publicly held corporations have been given almost unlimited discretion concerning the level of dividends.[4] More recent calls, including one by me,[5] for a reconsideration of this broad grant of discretion have not gained much traction. Rather, for good or for bad, the hostile takeover mechanism has been relied upon as the way to force greater dividend payouts from firms retaining too much of their earnings.[6]

1 Id. One indication of the company reluctance is the fact that when they decide to declare a dividend, it is often not paid until many months later.

2 S. Porshakov, supra note 2, at 11.

3 See, e.g., Public Laws and Resolutions of the State of North Carolina (1901), ch. 2, section 52; General Statutes of New Jersey (1895), P. L. 1891; New Mexico Statutes Annotated (1953), 451–3–16.

4 For a discussion of the demise of these rules and the development of a legal regime in which the directors of a publicly held corporation have almost unlimited discretion concerning the level of dividends, see Victor Brudney, Dividends, Discretion, and Disclosure, 66 VIRGINIA LAW REVIEW, 85 (1980). A classic statement of broad discretion given to directors even in closely held corporations is found in the textbook case, Dodge v. Ford, 204 Mich. 459, 500 (1919), 170 N. W. 668, 682.

5 Merritt B. Fox, Finance and Industrial Performance in a Dynamic Economy: Theory, Practice, and Policy 383–402 (1987); Zohar Goshen, Shareholder Dividend Options, 104 YALE LAW JOURNAL, 881 (1995).

6 Michael Jensen, The Takeover Controversy: Analysis and Evidence, The Revolution in Corporate Finance, Joel M. Stern & Donald H. Chew Jr. eds., 3d ed. 1998.

In Russia, though, there is a particularly strong rationale for a mandatory dividend payout and so proposals to impose one deserve especially serious attention. These same rationales apply as well to proposals to give dividend payments more favorable tax treatment.

2.3.2. The High Transaction Costs Objection

The obvious objection to such a rule is that expanding firms generally use internally generated cash flow as their first source of funds for their new investments. To force such a firm to pay out a portion of this cash flow as dividends requires that these funds be raised instead through outside finance. As a result, the objection runs, the firm incurs unnecessary additional transaction costs. Moreover, these transaction costs are particularly high in Russia both because asymmetries of information between corporate insiders and outside sources of finance are very high as an initial matter, requiring these sources to incur expensive investigation, and because they remain relatively high even after such sources of finance have incurred such expenses.[1]

2.3.3. The Benefits of Mandatory Dividends Despite Outside Finance Transaction Costs

The increased likelihood from mandatory dividends that firms will need to seek outside finance has a number of collateral social benefits, however, that in aggregate probably outweigh the social costs stemming from outside financing transactions.

1. Better discipline of management and control shareholders. A firm that is forced to raise external funds subjects itself to the scrutiny of the market. The prospect of facing this scrutiny disciplines management to do a better job both at operating existing capacity and finding the best

1 Stewart C. Myers & Nicholas S. Majluf, Corporate Financing and Investment Decisions When Firms Have Information that Investors do not Have, 13 JOURNAL OF FINANCIAL ECONOMICS, 187 (1984) (information asymmetries with outside sources of funds can cause corporations that would need such funding to invest in promising, positive net present value projects, rationally not to proceed); O. Lazareva et al, supra note 2, at 7 (capital markets in Russia are "plagued by information asymmetries").

new projects.[1] The prospect of such scrutiny also makes insider diversions of firm income and assets less likely.

Such scrutiny is particularly valuable in Russia because for most issuers, other disciplining mechanisms are weak. For example, the quality of periodic securities disclosure, though perhaps improving, is still poor[2] and the risks to incumbent management of hostile takeover are low or nonexistent. Many Russian corporations have a majority control shareholder, making takeover impossible. Even for those that do not, corporate law is quite protective of incumbents, in part because of an early experience of takeovers that were motivated by the intent to loot the target.[3] Information asymmetries also make secondary markets less liquid and as a result increase an issuer's cost of capital at the time of the initial offering of shares because low liquidity makes them less valuable to hold.[4]

2. Making salient the true cost investments using internal funds. Managers forced by a mandatory dividend rule to seek external financing for some of its investments are more likely to realize the true opportunity cost of the funds required for all the investment projects that they are considering, both those funded by remaining internal funds and those funded by external funds. While managers may tend to regard internally generated funds as "free money", they cannot do that with funds raised outside because outside funds have a self-evident cost of capital.[5] As a result, a dividend requirement is likely to reduce the number of negative net present value investment projects im-

1 See M. Fox, supra note 26, at 138–39; Frank Easterbrook, Two Agency Cost Explanations of Dividends, 74 AMERICAN ECONOMIC REVIEW, 650 (1984).

2 Porshakov S., supra note 2, at 8–9; 2004 Survey, supra note 2, at 16, 62–64. See also Part IV infra.

3 O. Lazavera et al, supra note 2, at 22–23.

4 Lawrence R. Glosten and Paul Milgrom, Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders, 14 JOURNAL OF FINANCIAL ECONOMICS, 71 (1985). Larry Harris, Trading & Exchanges: Market Microstructure For Practitioners 287–91, 299–302 (2003).

5 See, M. Jensen, supra note 20; M. Fox supra note 26 at 116–140; R. La Porta et al, Agency Problems and Dividend Policies around the World, 55 J. Fin. 1 (2000).

plemented by Russian firms and thus improve efficiency in the economy.[1]

3. Vitalizing capital markets. The flow of cash into the market generated by a mandatory dividend rule would also result in a pool of liquid funds that would create incentives for potential intermediaries to begin to build a real financial system. Among other benefits, this is likely to make the Russian economy more innovative. In the United States, a larger flow of dividends from established corporations would add to the economy's growth, promoting capacity for innovation by placing decisions relating to which new investment projects get funded into more imaginative hands.[2] This is likely to be at least as true in Russia because there is substantial evidence that new firms are more innovative than firms formed from former Soviet enterprises. (66)

4. Reducing information asymmetries. Akin to the "bird in the hand" theory of dividends in old-fashioned corporate finance texts,[3] forced dividends represent a valuable disclosure device in an economy where other means of disclosure often function poorly. Where directors are given discretion over whether or not to pay dividends, a firm lacking positive earnings can hide this fact by claiming that its earnings are positive but that they are being entirely reinvested. With a mandatory payout rule, the lack of earnings would quickly become obvious because the firm would likely not have sufficient cash to pay the dividends that the claimed level of earnings require.

In addition, because the high cost of outside finance is primarily a product of information asymmetries between outsiders and insiders, the need to seek outside finance creates incentives for those managers to enhance the scope and credibility of their financial and business

1 The 2004 Survey suggested, for example, that it was not necessarily be best for the large cash flows then being generated by the mineral extractive firms in Russia to be totally reinvested in these same firms. 2004 Survey, supra note 2, at 27, 29.

2 M. Fox, supra note 26, at 186–206; Merritt B. Fox, Promoting Innovation: The Law of Publicly Traded Corporations, 5 Capitalism and Society 1 (2010, Issue 3).

3 See, e.g., B. Graham & D.L. Dodd, Securities Analysis: Principles and Techniques, 432 (3d ed. 1951).

disclosures. They can do so by using devices such as having the firm retain accountants with a high reputation,[1] underwriting an offering of its securities with a high reputation investment bank[2] and cross listing its shares abroad in order to subject the firm to the strict mandatory disclosure regime of the country of the foreign market.[3]

Moreover, firms that choose this high disclosure route because of their need for more external finance would be aware that they would be able to further distinguish themselves from firms that hide their poor performance with low disclosure if all firms in the economy were subject to a stricter mandatory disclosure regime concerning their businesses and finances. Thus, because of the dividend requirement, the firms that choose this high disclosure route would form a natural political constituency to fight for a stricter mandatory regime. (67)

2.4. Enforcement of financial and business disclosure

Russia's adoption of international accounting standards for stock exchange-listed issuers, and of rules concerning business disclosure consistent with EU and IOSCO standards, are steps forward.[4] Without enforcement, however, these rules are just "law on the books." To be real, they must be enforced. There is significant evidence that

1 Linda D. DeAngelo, Auditor Independence, "Low Balling" and Disclosure Regulation, 3 JOURNAL OF ACCOUNTING & ECONOMICS, 113 (1981).

2 James R. Booth & Richard L. Smith, II, Capital Raising, Underwriting and the Certification Hypothesis, 15 JOURNAL OF FINANCIAL ECONOMICS, 261 (1986); Ann E. Sherman, Underwriter Certification and the Effect of Shelf Registration on Due Diligence, 28 FINANCIAL MANAGEMENT JOURNAL, (1999).

3 John C. Coffee. Racing towards the Top? The Impact of Cross-listings and Stock and Stock Market Competition on International Corporate Governance, 102 COLUMBIA LAW REVIEW 1757 (2002). A 2010 survey found that Russian corporations with US listings "are far more transparent" than their peer other Russian corporations. Standard & Poor's, supra note 3, at 15.

4 2004 Survey, supra note 2, at 14, 49.

because of law enforcement, disclosure by Russian corporations, though improving, is far from ideal.[1]

2.4.1. How Civil Liability Can Promote Economic Efficiency

A regime of civil liability imposed on some mix of issuers, directors, managers and gatekeepers for losses suffered due to an issuer's disclosure violations by both primary market and secondary market traders can be a powerful force for enforcement. Through its deterrent effects, such a regime can improve the quality of disclosure and, with the resulting improved share price accuracy, lead to a more efficient functioning of the economy. The more accurate prices are in the primary market – where issuers are offering securities to investors – the more likely that capital will flow to the firms with the most promising investment projects.[2] More disclosure and more accurate prices in the secondary market signal when managers are doing a poor job and help align the interests of managers with those of shareholders by assisting in the effectiveness of share price based compensation and the hostile takeover mechanisms for reducing the agency costs of management.[3]

Anecdotal evidence suggests that in the United States, fear of such liability may be the single biggest reason for compliance. Moreover, cross-country data collected by R. La Porta et al suggest that the presence or absence of civil liability is a key factor in explaining why some countries' securities regulation systems work and others do not.[4] This is not surprising: civil liability can fill in for many of the shortcomings that arise in connection with public enforcement.[5]

1 UNCTAD, supra note 19, at 5.

2 Merritt B. Fox, Civil Liability and Mandatory Disclosure, 109 COLUMBIA LAW REVIEW, 237 (2009).

3 Id.

4 Raphael La Porta et al. What Works in Securities Laws? 61 JOURNAL OF FINANCE, 1 (2006).

5 Merritt B. Fox. Why Civil Liability for Disclosure Violations When Issuers do not Trade, 2009 WISCONSIN LAW REVIEW, 299 (2009).

2.4.2. Procedural and Substantive Law Needed to Make the Threat of Civil Liability Real

For a system of civil liability to effectively deter disclosure violations, there needs to be some kind of mechanism for collective action. This is because, for most investors, it they were only able to act individually, the high costs of securities litigation would be greater than any expected recovery. Experience around the world suggests that only a system, like in the United States, involving an "opt-out" class action (a court approved procedure where each member of the class as defined by the person bringing the action is included unless, after a notice procedure, the putative member affirmatively opts out) combined with some method to pay the lawyer for the class such as a contingent fee system (where the lawyer receives a court approved percentage of any recovery) generates significant class litigation. Russia currently only has only "opt-in" class actions[1] and contingent fee arrangements seem at best rare and may not be allowed at all.[2] Also, for such class actions to provide an effective remedy, the underlying securities law cause of action cannot require the investor to show that he relied on the misstatement, because a reliance requirement would make an important element of the claim not be provable in common for the class as a whole. Instead the law must provide that the claim can be based simply on the argument that the misstatement raised the price of the security.

2.4.3. The Value to Russia Despite the Likely Only Small Near Term Effect

For Russia, imposition of civil liability for disclosure violations would be unlikely to play an important enforcement role in the short run because of the lack of a strong, effective, business-savvy judiciary. Centralized administrative

1 The Supreme Arbitrazh Court, the highest commercial court, promulgates procedural rules for commercial cases. Opt-in class actions are authorized. Arbitrazh Procedural Code, art. 28 (Russ.). Commonality of subject matter and the rights/duties of plaintiffs and defendants is required. Arbitrazh Procedural Code, art. 46 (Russ.).

2 Global Legal Group Limited, Class & Group Actions: Russia (2008) available at http://www.iclg.co.uk/index.php?area=4&country_results=1&kh_publications_id=166&chapters_id=3983.

enforcement, whatever its shortcomings, will need to be the principal tool for now.[1] Russia would nevertheless be wise to include within its legal system rules that give aggrieved plaintiffs a reasonable prospect of recovery, because, over the longer run, these rules could play an increasingly valuable enforcement role as the judicial system matures.

1. The argument that civil liability would serve no useful purpose. It might be argued that, at least in the case of secondary market trader losses due to an issuer's disclosure violations, an effective system of civil liability would serve no useful purpose because, for most Russian corporations, the majority of shares are owned by a single person, entity or control group. The behavior of such corporations, the argument runs, would be little influenced by any civil liability induced improvements in corporate transparency and share price accuracy because the majority shareholders of such corporations can get information without a civil liability backed system of mandatory disclosure and the minority play no role in governance.

Such an argument is short sighted for a number of reasons, discussed below, particularly if there is gradual progress overall in the competency of the judiciary and in the other reforms advocated here.

2. Signaling managerial and control shareholder breaches of duty in majority controlled corporations. Consider first improved transparency and share price accuracy in the secondary markets for the minority shares of majority owned corporations. To start, by signaling when there are problems, increased transparency and share price accuracy can assist both in the effective exercise of the shareholder franchise (where, for important interested transactions, a majority vote of disinterested shareholders – i.e. the outside shareholders – is needed) and in shareholder enforcement of management's duties to the corporation.[2]

1 See, Russian Corporate Governance Roundtable, Implementing International Financial Reporting Standards (IFRS) in Russia: 25 Recommendations to Facilitate the Transition to IFRS (2005).

2 See Merritt B. Fox, Required Disclosure and Corporate Governance, in 62 LAW & CONTEMPORARY PROBLEMS. 113 (1999). This is obvious when disclosures themselves suggest the possible existence of such

In addition, when there is sufficient disclosure to the market of information generated within the firm, market prices can predict a corporation's future cash flows better than can the majority control shareholder. This is because the market price, in addition to reflecting the information generated within the firm that has been disclosed, reflects as well the differing sets of information and expertise held by outside buyers and sellers of a corporations shares. These sets of information and expertise held by outsiders concern the environment in which the corporation operates and consequently are useful in refining the assessment of what the corporation's future cash flows are likely to be. Thus market prices can guide control shareholders to making decisions that better enhance firm value.

Also, where the majority shareholders do not themselves run the firm day-to-day, agency costs arise from the separation of management from ownership, just like in a firm with truly dispersed ownership. By reducing the riskiness associated with holding a corporation's stock in a less than fully diversified portfolio, additional disclosure increases the willingness of managers to take a larger share of their compensation in share price based form. This provides greater incentives for managers to make firm value maximizing decisions and hence reduces these agency costs.[1]

3. Better allocation of capital. Improved price accuracy in the primary market for the shares of majority owned firms is socially useful as well. Greater share price accuracy at a time when such a corporation contemplates financing a new project by means of a share offering will bring the corporation's cost of capital more in line with the social cost of investing society's scarce savings in the contemplated project. As a result, these savings are allocated more

a problem. It also can occur when a share price declines, indicating, if the price has a relatively high level of accuracy, that something is amiss.

1 See Merritt B. Fox, Securities Disclosure in a Globalizing Market: Who Should Regulate Whom, 95 MICHIGAN LAW REVIEW, 2498, 2548–50 (1997).

efficiently, going more consistently to the most promising proposed projects in the economy.[1]

4. Increasing the possibility of dispersed ownership corporations. Finally, looking toward the future, the argument that civil liability induced improvements in transparency and share price accuracy serve no useful purpose because most Russian firms are majority owned ignores important reasons why majority owned firms currently predominate in Russia. In a world where there are inadequate protections for non-control shareholders, securities cannot be offered at a price equal to their pro-rata claim on projected future cash flow of the corporation. Non-control shares sell at a steep discount and so a majority shareholder pattern of firm ownership dominates.

Civil liability induced improvements in transparency and share price accuracy and the other reforms discussed here would tend to reinforce each other and move Russia toward a day when the conditions allowing for truly dispersed ownership corporations begin to play a significant role in the Russian economy. The practical availability of this form of corporate ownership would have distinct advantages. It reduces investor risk by permitting greater diversification. It also appears to enhance entrepreneurship and innovation by allowing venture capitalist to exit via initial public offerings.[2]

2.5. The role of stakeholders

The appropriate role of non-shareholder stakeholders and their interests in the governance of the corporation has been the subject of a hard fought transnational debate. In the United States, a rough consensus seems to have formed among most (though not all) academic commentators that the proper goal for good corporate governance is that the firm should be operated to maximize

1 See Merritt B. Fox, Retaining Mandatory Disclosure: Why Issuer Choice is not Investor Empowerment, 85 VIRGINIA LAW REVIEW, 1335, 1358–63 (1999).

2 Bernard S. Black & Ronald J. Gilson. Venture Capital and the Structure of Capital Markets: Banks versus Stock Market, 47 JOURNAL OF FINANCIAL ECONOMICS, 243 (1996).

its residuals – the difference between what the firm pays at contractually pre-determined prices for its inputs and what it receives for its outputs – over the life of the firm discounted to present value. Doing so maximizes the social wealth generated by the real operations of the corporation, at least assuming that firms are operating in competitive markets and the potential externalities, such as environmental damage, resulting from their activities are properly regulated. The theory is that under these circumstances, the value of what the firm takes from society is, at the margin, properly measured by what it pays out at market determined prices for contractually obtained resources, and the value of what it contributes to society, at the margin, is what is receives at market determined prices for its output. The difference – the residual – is the firm's value added and its contribution to society.

For investor-owned firms, shareholders are the recipients of these residuals. Thus, according to the US consensus, such firms need to operate in a fashion that maximizes share value. This need in turn suggests that the directors of the corporation should primarily represent the shareholders.

In Europe and Japan, many voices advocate that the governance mechanism of the corporation be designed to take significant account of the interests of other stakeholders. These other stakeholders include labor, the communities in which the corporation operate and customers. According to this view, these interests should be taken into account even when decisions furthering these interests reduce share value. The larger society is injured when the governance mechanism fails to take the interests of these stakeholders into account because of the resulting disappointment of expectations that, though not protected by formal contract, are long and deeply held. One way to take account of these interests is for other stakeholders to have a formal role in the firm's governance, for example the representation of labor on the supervisory board under the German scheme of co-determination. Another, less extreme, way is to include among the duties of directors the obligation to take account of such interests.

Corporate decisions that advance the interests of other stakeholders beyond what is required by the corporation's existing contracts may, of course, enhance share value at the same time. For example, a firm's discounted-to-present-value aggregate future residuals, and hence its share value, might increase if, despite a cost in terms of current earnings, the firm develops a reputation among current and potential workers as a good employer or among consumers as a "green" company that works to reduce global warming. Where careful, serious analysis suggests that a decision advancing the interests of other stakeholders can genuinely be expected to enhance share value, the stakeholder model simply collapses into the share value maximization model. Beware, however, of the self-evidently overly broad generalization that at least in the long run, doing good for other stakeholders consistently benefits shareholders as well. The happy incantation of this generalization by some authorities evades the fact that often an act which benefits other stakeholders reduces share value. As a consequence, a choice between the share value maximization approach and the stakeholder approach cannot be avoided.

Which approach is better for Russia? In my view, the case for the share value maximization model is especially strong. One reason is historical. The particular pattern of privatization of state enterprises in Russia involved incumbent managers, employees and local governments each receiving significant blocks of stock. This led to a situation where restructurings that could have greatly enhanced the value of the enterprise failed to be undertaken. Instead, each of these shareholder blocks, rather than trying to maximize the pie that they could then split up as shareholders, looked, as in Soviet times, to the corporation to provide them with direct benefits beyond what they could command if they offered their services in the outside market.[1] This problem may have lessened over time as labor and local government shareholders have been

1 See M. Fox & M. Heller, supra note 1, at 1752–58, for a history of such behavior and analysis of why the different blocks could not cooperate to bring restructurings that would ultimately generate more total wealth to divide among themselves.

squeezed out. The power of this example from near history continues to pose special dangers, however.[1] Granting non-shareholder stakeholders in Russia a formal role in corporate governance risks again using their influence to obtain direct benefits from the corporation in ways that are not social wealth maximizing.

Even if other stakeholders are not given formal roles and their interests are simply added to the list of legitimate objectives of Russian directors and managers, the resulting problems may be particularly severe in Russia.[2] The multiple stakeholder model of corporate governance provides less clear-cut criteria for judging the quality of corporate decisionmaking. As a result, directors and managers can claim a concern with other stakeholders as a cover for decisions favoring their own interests. In the United States, for example, the interests of other stakeholders have most frequently been invoked by incumbent managers of publicly-held corporations as an excuse when they are fending off hostile takeovers that would deprive the managers of their own jobs. The problem of directors and managers invoking other stakeholder interests as a cover is likely to be particularly great in Russia, where the institutionally-based corporate governance constraints on management are already weak.

A good example of Russian attitudes toward the question of stakeholders is found in the National Council on Corporate Governance 2004 survey of Russian corporate

1 For companies where the majority of shares originally went to managers and employees, which usually ended up latter as predominantly owned by managers, the legacy of these effects may have extended a decade or more, with companies retaining inefficiently large labor forces. See Yaraslav Kryvoi, Employee Ownership and Corporate Governance in Post-Privatization Russia, 8 UNIVERSITY OF CALIFORNIA – DAVIS BUSINESS LAW JOURNAL, 298 (2009).

2 Members of the board and the management are obliged to act in accordance with the principles of good faith and reasonableness in the interests of the corporation. Federal Law on Joint Stock Companies, Federal Law No. 208-FZ, art.71 (Russ.). Because the corporation is a legal fiction, the question of the share value maximization model versus the stakeholder model is one of how to define the interests of this legal fiction – the corporation – the decisions with respect to which affect a variety of kinds of real individuals.

governance.[1] Another example, from Poland but reflecting views about all eastern European economies including Russia, is a 2007 survey by Piotr Kozarzewski,[2] and yet another also a 2007 Russian corporate governance survey by Olga Lazareva et al.[3] The 2004 Survey approaches gingerly the question of the role of other stakeholders in Russian corporate governance. On the one hand, it recounts the unfortunate problems that arose from the pressures that labor and local governments put on recently privatized enterprises in the 1990's.[4] On the other hand, it seems to characterize the share value maximization approach as reflecting the thinking of the now past 1990s.[5] Moreover, the Survey relates the recommendation of the Code of Corporate Conduct that "management and board members heed the interests of all stakeholders – employees, the company's partners, the federal and local governments" with seeming approval, suggesting that "reaching a balance of all stakeholders' interests is essential for the company's best, sustainable performance."[6] The issue of how much attention to pay other stakeholder interests is a live one in Russia because a corporation's adoption of the various provisions of the Code of Corporate Conduct is voluntary.[7]

P. Kozarzewki is similarly diffident, suggesting that the involvement of other stakeholders through tradition and their at least initial shareholdings was one argument why the "Continental" model of corporate governance was better for Russia "at least in the first stages of transition."[8] O. Lazareva et al similarly conclude that the "broader perspective of corporate governance" that takes account of stakeholders is "more appropriate for Russia since

1 2004 Survey, supra note 2.

2 P. Kozarzewski, supra note 9.

3 O. Lazareva et al, supra note.

4 Id. at 51–52.

5 Id. at 51.

6 Id. at 52.

7 Id. at 33, 40, 46–47.

8 P. Kozarzewski, supra note 9, at 14–15.

stakeholders, primarily governments of different levels and workers play an important role in a firm's decisions."[1]

It would have been better if these authorities had confronted more forthrightly the disadvantages of the stakeholder approach and explored whether or not in Russia the interests of the other stakeholders can be adequately protected by contract, as share value maximization model adherents believe is the case in the United States, rather than simply accepting the *status quo* with regard to the question of stakeholder involvement as the starting point for a normative analysis. This is especially true if the governance of SOEs is treated as a different subject and the focus is on the corporate governance needs of non-SOEs.

2.6. Conclusion

This short comment argues that the questions surrounding the governance of SOEs and non-SOEs are sufficiently different that they should be analyzed separately. The focus here is on non-SOEs. The comment contains some practical suggestions with respect to four important issues in Russian corporate governance: disclosure of beneficial ownership, dividends, enforcement of financial and business disclosure requirements, and the role of non-shareholder stakeholders in corporate governance. Adoption of each of these suggestions would require political will, because important interests would be negatively affected. But each would contribute to getting corporate governance right in Russia. Going forward, these improvements could be of real value to the country as a whole.

Russia's robust economic growth over the last decade has been largely due to increases in the utilization of existing capacity and the runup in oil and other mineral prices.[2] Capacity is now much closer to being fully utilized and any continued, further runup in oil and other mineral prices cannot go on forever. Thus much of any future growth must come from better, not just fuller, use

1 O. Lazareva, supra note 2, at 3.

2 2004 Survey, supra note 2, at 21–35.

of existing capacity and new investments that increase the wealth-generating capacity of firms in the non-mineral-extractive sectors. Obviously many kinds of reforms are necessary, the most important probably being an overall reduction in the stultifying state involvement in the economy that, among other things, makes it time-consuming and difficult to get new manufacturing capacity on line. Further reforms in corporate governance, though, are needed as well so that institutions develop that will spur the most productive use of existing capacity and permit the firms with the most innovative and promising investment projects to get the funds they need.

Chapter III

CORPORATE GOVERNANCE IN RUSSIA IN 2011: OLD PROBLEMS AND NEW CHALLENGES

Oleg Shvyrkov[1]

As the results of 2011 have shown, corporate governance problems at Russian companies are widely known to capital markets, causing discounts and contributing to volatility of Russian stocks. This perception invariably increases the cost of capital and narrows down the investment opportunities available to Russian companies.

We summarize the activity of Russian companies on the equity markets in the first part of this Chapter. Against the background of moderate total of 17 public placements, that had raised an aggregate of mere US$ 10 billion, and lackluster performance of most placements, the example of Magnit OJSC that successfully raised US$ 475 million in a secondary placement in the second half of 2011, stands out. It is quite clear that investors recognize and appreciate the efforts taken by individual Russian

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