attracting a high degree of attention from policymakers and the media alike, it is just one aspect of the issue.

Chairs and nomination committees should adopt a wide interpretation of diversity to include a mix of cultural, functional and generational experience. Boards that are not only gender diverse, but possess a range of human capital qualities are more likely to be in touch with customers' demands, investor expectations, and the concerns of staff. They can also provide enhanced understanding of emerging markets, specialist knowledge and new industry trends.

The UK boardroom has come a long way in the aftermath of the crisis – and in the areas of risk, audit and board composition – still has a long way to go.

Chapter VI

TOWARDS IMPROVING RUSSIA'S BOARDS OF DIRECTORS

Sergey Guriev[1]

The author of this Chapter is both an academic scholar of corporate governance and a corporate governance practitioner being a board member at several state and private companies and non-for-profit organizations. As researcher, he will present the competing theoretical models of how a board of directors functions (Section 1) and will also provide an overview of the available empirical studies of boards of directors both within and outside Russia (Section 2). In Section 3, as a practitioner, he will present his personal views on what can and should be done to enhance efficiency of boards of directors in Russian companies.

6.1. Boards of directors: theoretical ideas

There are three competing models of boards of directors. Firstly, there is a model of an 'ideal board' that is present in introductory textbooks. Even though all of us understand that this ideal can hardly be achieved, such a model is very useful as a benchmark. Second, there a is

1 Sergey Guriev, Rector, New Economic School, Board Member of Sberbank, Russian Venture Company, Russian Home Mortgage Lending Agency, Alfa-Strakhovanie and Dynasty Foundation.

cynical view of the boards where boards are seen just as a smokescreen and where the management appoints and controls the boards completely. Third, there is the model of 'friendly board', whereby the board members are willing to perform their duty to shareholders but their ability to do their job is constrained by the information they can obtain from the management only; therefore the board members cannot clash with the management but have to maintain friendly relations.

6.1.1. The 'Ideal Board'

The conventional view of a board of directors relies on the analogy between a corporation and a polity. Just as the parliament represents legislative power in a republic, the board of directors does in a corporation – very much as the term 'corporate governance' is similar to the 'governance' of a state. If we continue this analogy, the CEO plays the role of the President, the Management Board – that of the Cabinet of Ministers, and the Board of Directors – that of the Parliament. The board of directors is elected by shareholders (the electorate). Just as in politics where presidential and parliamentary republics exist, there are different systems in corporate governance, with more or less important roles of the board vs. the management. Just as in politics, the board of directors has two key functions, the legislative (to define the rules, by which the corporation operates) and the controlling ones (to make sure that the management abides by these rules).

Accordingly, in the perfect case, most (or even all?) board members should be independent from the Management Board – in the sense that the CEO cannot influence their decisions. On the contrary, it is CEO who should be accountable to the board – just as the board should be accountable to shareholders.

The analogy between the corporation and the republic is, of course, useful but not perfect. It should certainly not be taken literally. There are many important differences between politics and corporate governance. Firstly, the corporate governance relies on the 'one dollar – one vote' rule – rather than 'one voter – one vote'. It enables to concentrate ownership and to 'vote with one's

feet' through selling shares (which immediately results in the fall of the company's stock price).

Second, it is much easier to measure the performance of the corporate governance institutions. Even though the goals are similar (the CEO acts in shareholders' interests while the executive branch of the government pursues citizens' interests), the success criteria in the corporation may be quantified easily and quickly (e.g. through the company's market value).

Third, corporations are much smaller and less important than states. Therefore, career in public administration brings much more 'power' and 'fame', whereas corporate governance has to rely much more on financial incentives rather than, for instance, patriotic or ego-related factors. Also, one person may be a board member in several companies but not in several states.

This is why it is not surprising that while the board of directors is a key corporate governance institution but it is not the only one.[1] As success can be easily measured, it is possible to create both contractual and career incentives for management. Also, 'voting with one's feet' may lead to both hostile takeovers (somewhat like military aggressions for states but those have become much less important recently) and/or property concentration which are both crucial for corporate governance. And when property is concentrated, major shareholders become able to directly monitor the management.

Of course, the board of directors remains the key corporate governance institution – without it, all other mechanisms cannot operate efficiently. It is the board that determines quantitative targets and the management remuneration structure. It is the board of directors that resolves whether to approve or to deny the proposals as to mergers and acquisitions. It is through the board of directors that major shareholders control the management. Nonetheless, existence of alternative tools means that

1 See the overview of corporate governance tools and relations among them, e.g. in Becht M., Bolton P., and Roell A. "Corporate governance and control," in: Constantinides G.M., Harris M., and Stulz R.M. (ed.), Handbook of the Economics of Finance, edition 1, vol. 1, chapter 1, pages 1–109, Elsevier, 2003.

the role of the board of directors in a modern corporation is much less important than that of a parliament in a polity. This is why, the board holds meetings just several times a year, and its members normally have another full-time employment. So a company even does not provide administrative assistance for each board member. And this is why elections to the board take much less time and efforts than those to the parliament.[1]

Where do the board members' incentives come from in the ideal model? Firstly, these are electoral incentives – board members understand they might not be elected next time and might lose their salary. Secondly, these are career and reputation-related considerations: if it becomes known that the board members performed poorly or contrary to the shareholders' interests, it would be difficult for them to get elected to another board. Thirdly, it is the fiduciary duty – shareholders may sue the board members for poor performance, and in this case, board members may incur major financial losses or even go to jail.

Obviously, for electoral and career incentives to work, a board member's salary must be very high – much higher than the one that would make up for his/her direct time cost.[2] Besides, it is necessary to ensure transparency of the board operation – so that the shareholders would understand why the board makes any particular decision and, consequently, would punish its members for mistakes, lack of attention or dishonesty.

1 Recently, the efficiency of board elections has improved substantially through the work of ISS/RiskMetrics (recently acquired by MSCI). In fact, it acts as a rating agency for the board of directors, by assessing the quality of corporate governance in a corporation, advantages and reputation of individual candidates for the board members. ISS/RiskMetrics gives shareholders recommendations on whom to vote for, and the overwhelming majority of institutional investors follow its recommendations. Even though this body may make mistakes in its assessments, its reputation has generally been very high. Therefore, even with limited resources, it is possible to ensure quite efficient voting.

2 This is the well-known argument of the 'efficiency wage' theory, see, for instance, Shapiro C., and Stiglitz J. 'Equilibrium unemployment as a worker discipline device,' AMERICAN ECONOMIC REVIEW, 74, 1984, 433–44.

To ensure the effectiveness of fiduciary duty, it is extremely important to have an honest and competent judiciary system as well as the directors' liability insurance. If there is no liability insurance, shareholders will not have the incentives to go to court, because the board members' personal property is unlikely to be sufficient for compensating the shareholders' losses. If there is a liability insurance (with a deductible to be paid by the board members themselves), shareholders will have incentives to sue the board members, and the board members will have incentives to avoid such situations.

6.1.2. A Pessimistic View of Boards

There is also a cynical view which assumes the boards to be fully dependent on the management.[1] According to this view, the boards are appointed by the CEO (for instance, out of his/her personal friends), and the elections of board members are a simple formality. In this case, board members receive high salary and know that any attempts at challenging the management would lead to their removal from the board – and they will not be elected to other boards.

Such situation is possible and even normal, if elections of the board members are arranged by the management, whereas independent candidates cannot get into the board. In this case, any board member knows that, when interests of the management and those of shareholders are not aligned, he/she should act in the management's, not the shareholders', interests. It is important for this view that the elections are arranged by the management in most companies; otherwise the independently-thinking board members would not be afraid to oppose the management as they would be welcome as board members in 'democratic' corporations.

The existence of management-controlled boards seem to be 'puzzle'. Indeed, companies with worse corporate governance have lower market value[2] – so why should

1 See, for instance, Bebchuk L. and Fried J. Pay without Performance: The Unfulfilled Promise of Executive Compensation. Cambridge: Harvard University Press, 2004.

2 Gompers P., Ishii J., and Metrick A. 'Corporate Governance and Equity Prices.' QUARTERLY JOURNAL OF ECONOMICS, 118 (1), 2003, 107–155.

the management be interested in such a board? The solution to this 'puzzle' is best understood through an analogy with the political governance: many dictators also prefer inefficient political institutions, because efficient ones may deprive them of their power. If a general manager realizes that he/she is not the most competent candidate for his/her position, he/she understands that, if the corporate governance tools operate well, he/she would lose his/her job and the respective fringe benefits. Therefore, he would prefer to have a controlled board and low capitalization. If the fringe benefits from being a general manager are very high (just as those from being a dictator in a polity), he/she would prefer inefficient mechanisms.[1]

6.1.3. Role of Information and the 'Friendly Boards'

Even if we suppose that the board members are interested in pursuing shareholders' interests, this will not happen automatically. In order to perform its work well, the board needs a huge amount of information.[2] A modern mega-corporation is a very complex organization. Obviously, obtaining information on the operations of the company takes much time and efforts. Moreover, it is this very fact that creates the need for the board. The fact that getting information takes efforts, time and money makes shareholders delegate their powers to the board. If it were possible to get such information without any expenses whatsoever, the board of directors would become unnecessary – shareholders would obtain it without intermediaries.

The main difficulty is that the principal source of information on the company is its top management itself. What are the alternative information sources? First, there are so-called gatekeepers, e.g. auditors and rating agencies. Second, the ones from within the company, both institutional (e.g. the internal audit service and the risk management service) and *ad hoc* ones (whistleblowers). Boards

1 See, for instance, Acemoglu D. (2003), 'Why Not a Political Coase Theorem? Social Conflict, Commitment and Politics,' JOURNAL OF COMPARATIVE ECONOMICS, 31, 2003, p. 620–652.

2 The worst-case-scenario presupposes that the board does not even try to control the management, so it does not need such information.

of directors are paying increasingly more attention to these sources,[1] but their capabilities are limited. By definition, these are the top managers who have much more comprehensive information on the company.

The willingness of top managers to share all information available to them may only result from a trusting relationship between the board and the management. This particular assumption forms the basis of the friendly boards theory,[2] which assumes that the most effective boards of directors are the ones in companies where the management feels fairly self-confident and is not afraid of the board's monitoring. If the management is rather weak (e.g. it does not hold a significant stake), the situation automatically rolls to the 'bad equilibrium' where the board is unable to perform its functions properly.

6.2. Empirical studies of boards

6.2.1. An Overview

The quantitative studies of boards of directors are to provide answers to the two fundamental questions: what factors the boards' measurable characteristics (such as composition, quality, structure, modes of operation) depend on and what they influence. Most studies focus on the share of independent directors, the independence of the board's chairman, size, frequency of meetings, agenda etc.

Unfortunately, most of these studies have not yet delivered any conclusive statistically significant results so far. For instance, the recent comprehensive survey by Rene Adams, Benjamin Hermalin and Michael Weisbach arrives at this conclusion.[3] There are some exceptions to be discussed below, but the general state of this literature is as follows: there are no convincing results that link characteristics of boards of directors with the corporate performance.

1 Sarbanes-Oxley Act of 2002 focuses on both of these sources.

2 Adams, R., and Ferreira, D. "A Theory of Friendly Boards," JOURNAL OF FINANCE, 62 (1), 2007, 217–250.

3 Adams R., Hermalin B. and Weisbach M. "The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey," JOURNAL OF ECONOMIC LITERATURE, 48 (1), 2010, 58–107.

There three potential explanations. Firstly, this is the above-mentioned 'pessimistic view' of boards: boards are controlled by the management and therefore do not matter.

Secondly, it can be explained by the measurement issues: boards do matter but we still cannot measure their impact. While one can measure the age of board members, their work experience, education, salary, frequency of their meetings. However, the board's work takes place behind closed doors and, generally speaking, a researcher does not have access even to minutes of these meetings not even speaking of the details of the discussions.

The third explanation is methodological, related to the absence of methods of setting up natural experiments. How would an ideal experiment look like in this case? Suppose, we believe that a board with property X performs well, and the one property Y functions poorly. Then, it is necessary to consider two similar companies and cast a coin. If the coin falls heads up, we should set up the board with property X in the first company, and the board property Y in the other company. If the coin falls tails up, we should do the opposite. Then we will measure the company's operating results. Moreover, in order to achieve statistical significance, this experiment should be repeated for many different pairs of similar companies so the researchers have a large number of observations. Certainly, we are unlikely to see such experiments in any foreseeable future.

So we inevitably face the endogeniety issue. Suppose that companies know how to design a good board. But the companies also know that it takes money, efforts and time to establish a better board. Then it is quite possible that company A where other corporate governance mechanisms operate well will not establish a professional board, whereas other mechanisms do not work well in company B, so it will prefer to set up a strong board. As a result, researchers will obtain the following results: both A and B have similarly strong performance, though their boards are quite different. This is a completely natural result: if we cannot measure the expenses of establishing a board and the features of other mechanisms, we see two successful companies, the one (B) with a 'good' board, and the other one (A) with an 'inadequate' board, though their performance is similar. Even though the causal relationship exists, it cannot be detected by simple econometric methods.

6.2.2. Selected Empirical Results

Nonetheless, certain features of the board are found to affect the company performance. For instance, Michael Weisbach shows in his work that, while the number of independent directors does not directly influence a company's performance, it impacts the relationship between the company's performance and the likelihood of the CEO's dismissal; and the more numerous the independent directors, the stronger the relationship.[1] This result rather proves that not all boards work perfectly, but those built in accordance with the 'perfect model', perform their function rather well.

Another result that is rather consistent with the 'pessimistic view' is related to the role of staggered boards. In certain companies, boards are not elected simultaneously for one year, but for overlapping periods of time; for instance, every year a third of the board is re-elected for three years. Accordingly, if the company's majority shareholder changes, such shareholder may re-elect only a third of the board and has to live (at least, for one year) with the board, most of which was appointed by his/her predecessors. This setup seems to protect the board not only from the shareholders but also from the management. A number of studies[2] suggests that staggered boards serve as a tool to protect management against hostile takeover and, consequently, the method of relaxing shareholders' control. Studies (in particular, using virtually perfect natural experiments) also demonstrate that, if a company shifts from

1 Weisbach M. "Outside Directors and CEO Turnover," JOURNAL OF FINANCIAL ECONOMICS, 20 (1/2), 1988, 431–460.

2 Bebchuk L., Coates J., and Subramanian G. "The Powerful Antitakeover Force of Staggered Boards, Theory, Evidence, and Policy," STANFORD LAW REVIEW, 54, 2002, 887–952; Bebchuk L., and Cohen A. "The Costs of Staggered Boards," JOURNAL OF FINANCIAL ECONOMICS, 78, 2005, 409–433; Bebchuk L., Cohen A., and Wang C. "Staggered Boards and the Wealth of Shareholders: Evidence from Two Natural Experiments." Harvard Law and Economics Discussion Paper No. 697, 2010. Available at SSRN: http://ssrn.com/abstract=1706806.

staggered boards to simultaneous election of the board members, the share price increases.

Some results are consistent with the model of 'friendly boards'. Rene Adams and Daniel Ferreira[1] quantified the CEO's 'strength' by his/her shareholding and his/her professional experience in this position. They found strong CEOs not to be afraid of sharing information because they had not fear that the board would punish or dismiss them. R. Adams and D. Ferreira discovered a non-linear relationship between the managers' strength and the number of independent directors: at first, if the CEO is very weak, the number of independent directors in the board is smaller because he/she is afraid that he/she would be monitored too closely. But as the CEO's strength increases and surpasses a certain threshold, he/she is no longer afraid of independent directors anymore. Then he/she provides them with comprehensive information, because it pays off: shareholders trust in this company, invest more money into it and, consequently, its stock price goes up. The CEO feels so strong that he/she is not afraid of independent directors – and further increase in his/her influence is associated with the growth in the number of independent directors in the board.

Another indirect argument for the 'pessimistic view' model or the 'friendly boards' model is that the separation of positions of the board chairman and the CEO is not correlated with corporate performance. These results imply that separation of these positions does not deprive the CEO of too much power, because he/she still has comprehensive information. Even though the CEO is not the board chairman, the agenda is shaped under his/her influence. A better informed director, without having *formal* powers, has *actual* powers.[2] In other words, empirical studies have not yet provided conclusive results on what model provides the best description of the boards of directors.

1 Adams R., and Ferreira D. "Strong Managers, Weak Boards?" Available at SSRN: http://ssrn.com/abstract=1409833, 2009.

2 Aghion P., and Tirole J. "Formal and Real Authority in Organizations." JOURNAL OF POLITICAL ECONOMY, 105, 1997, 1–29.

6.2.3. Studies of Boards of Directors in Russia

There have been only three large empirical studies of Russian boards in recent years. The first one is the annual survey of top 150 companies held by the Russian Institute of Directors (RID). In 2011, this survey was implemented together with the New Economic School (NES).[1] In particular, its authors tried to understand what characteristics of boards of directors depend on and what they influence; however, they did not get any robust statistically significant results. Two earlier studies were conducted by I. Iwasaki[2] who interviewed 730 companies and by O. Lazareva and T. Summanen[3] who studied 200 companies. Their results do not suggest any robust relationship between the composition of the board of directors and the company's performance. Nonetheless, these research projects provide a general idea of the composition of Russian boards of directors.

Table 6 is based on the RID data. In their sample, about 1/3 companies have no independent directors; they exist but account for less than a 25% of the board in another third, and it is in the last third independent directors number more than 25% board members. We notice that, starting from 2004, the situation has improved; though it has stabilized to some extent recently.

1 Survey of Corporate Governance Practice in Russia: Comparative Analysis based on 2004/2009 Results. Survey by the Russian Institute of Directors, with participation of the New Economic School. RUSSIAN MANAGEMENT JOURNAL, 9 (1), 2011.

2 Iwasaki I. "The determinants of board composition in a transforming economy: Evidence from Russia." JOURNAL OF CORPORATE FINANCE, 14, 2008, 532–549.

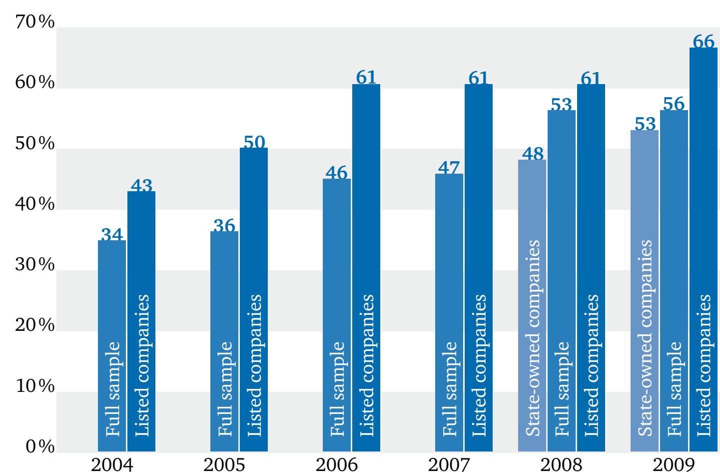
3 Summanen T., and Lazareva O., "Emerging Boards of Directors: Board Behavior, Functions and Firm Performance." Available at SSRN: http://ssrn.com/abstract=1102473, 2008.

Table 6. Composition of Corporate Boards in Russia

	Full sample					
	2009	2008	2007	2006	2005	2004
At least one independent director, including:	66%	70%	66%	55%	45%	52%
Independent directors make up for more than one fourth of the board of directors composition	33%	38%	32%	23%	23%	28%
Independent directors make up less than one fourth of the board of directors composition	33%	32%	34%	32%	22%	24%
There are no independent directors in the board of directors	34%	30%	34%	45%	55%	48%

Source: RID, 2011.

Fig. 4 describes the share of companies that comply with RID's corporate governance recommendations. These recommendations are based on the best international practices and include the roles of independent directors, regular board meetings, establishment of audit and nominations/renumeration committees. We see that the share of companies with good corporate governance is about a half and is growing; but the growth is slow.



Notes: *The Figure shows the share companies that comply with RID's recommendations on the Governance Bodies. Source: RID, 2011.*

Fig. 4. Corporate Governance Trends in 2004–2009

Table 7 shows the frequency of board of directors meetings. Almost all of the companies hold meetings at least quarterly.

Table 7. Frequency of Holding Board Meetings

	Full sample					
	2009	2008	2007	2006	2005	2004
Meetings are held more frequently than once a quarter, including:	99%	97%	90%	84%	75%	79%
Meetings are held once in six weeks or more frequently	73%	64%	59%	45%	41%	49%
Meetings are held less frequently than once in six weeks but more frequently than once a quarter	26%	33%	31%	39%	34%	30%
Meetings are held once a quarter or less frequently	1%	3%	10%	16%	25%	21%

Source: RID, 2011.

Table 8 shows data on the board committees. A third of companies prove not to have the nomination and remuneration committees. These data suggests that the situation improves, apparently, in particular, due to the reform of corporate governance in the state-owned companies.

Table 8. Board Committees

	Full sample					
	2009	2008	2007	2006	2005	2004
The audit committee is established in the board of directors	77%	69%	51%	41%	32%	23%
The nomination/ remuneration committee established in the board of directors	65%	55%	33%	27%	23%	19%

Source: RID, 2011.

Table 9 suggests that 41% of the companies have directors who are members of more than five boards. It points to a dire shortage of board members in Russia. The situation has not improved in recent years. This table implies that increasingly more companies create boards of directors so that the demand for board members grows faster than their supply.

Table 9. Share of Board Members Who Are Members of at Least Five More Boards

	Full sample					
	2009	2008	2007	2006	2005	2004
The board of directors includes directors who are members of boards in five other companies.	41%	41%	45%	44%	33%	26%

Source: RID, 2011.

I. Iwasaki also provides a number of interesting findings. Most companies from his sample are not listed companies, so the results are not very surprising. Nonetheless, they are interesting: these boards of directors are not large – in fact, they are much less numerous than in other countries, on average 7 persons. Curiously enough, the share of independent directors is rather high. **Figure 5** shows the breakdown of the sampling by the board size: many companies have 7 or 5 members in their boards; there are even companies with 3-members boards. Probably, the latter ones are fictitious and comprise the CEO and two or three of his/her deputies.

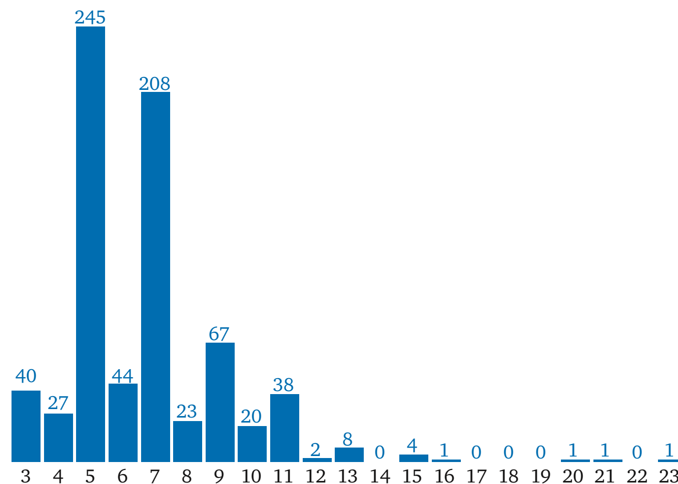
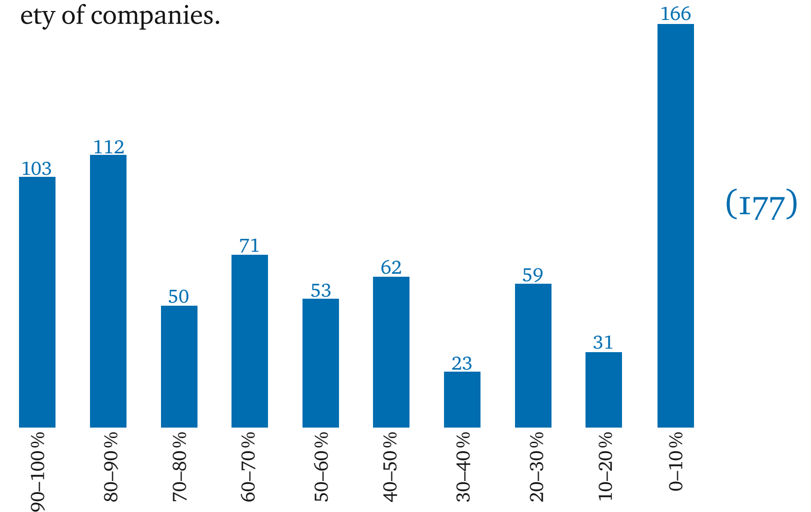


Fig. 5. Boards of Directors by Size

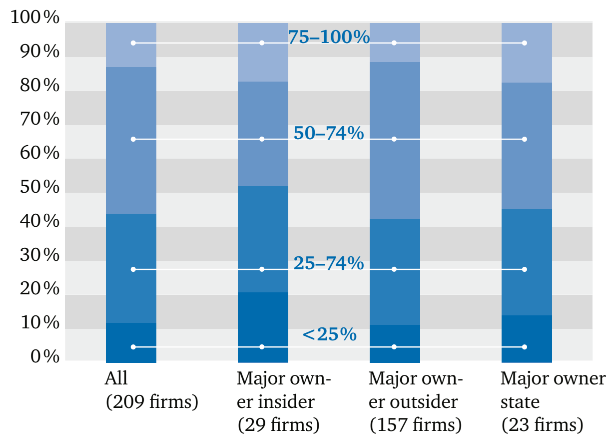
Figure 6 shows the breakdown of the sample by the share of independent directors. In 166 out of 730 companies, independent directors account for less than 10%. At the same time, we see companies with majority or even overwhelming majority of independent directors. Apparently, the Iwasaki sample proves to contain a great variety of companies.



Note: *The horizontal axis shows the share of independent board members, and the vertical one – the number of companies in the sample with the respective share of independent directors. Source: Iwasaki (2008).*

Fig. 6. Boards of Directors by the Share of Independent Directors

T. Summanen and O. Lazareva (2008) studied a sample of large companies. **Figure 7** shows that there companies have concentrated ownership. It is not surprising that in these companies the boards mainly advise the management rather than control/monitor it. T. Summanen and O. Lazareva surveyed the respondents on the agenda of board meetings. They showed that, unlike the US companies, Russian boards (at least in their sample) spend most of their time on advising the management on strategy, rather than on monitoring of the management's operations.



Note: *T. Summanen and O. Lazareva (2008).*

Fig. 7. The Summanen-Lazareva Sample (2007) by the Share of the Largest Shareholder

These empirical studies imply that the boards of Russian companies are still in transition. The ownership structure has not yet settled; the companies are still to create boards and committees within boards; independent directors perceive themselves rather as advisors, not as controlling bodies. In this sense, Russian boards of directors are largely either 'controlled' or 'friendly'. What should we expect to happen in the future?

First, despite fairly high quality of Russian corporate law (which is even better than in the USA, in many aspects), its enforcement is rather limited, because the Russian judicial system is still much less independent and competent in corporate governance than it is in the US or in the UK. This limits fiduciary and reputational incentives of board members significantly.

Secondly, there is still a shortage of qualified board members in Russia. Who serve on the corporate boards in the US? These are individuals who, for instance, have made a successful business career and are now able to devote substantial time to working as board members in other companies. In Russia the entrepreneurs, who established their businesses 20 years ago and are still running them,

continue to be active businessmen or managers. They have no time to work on the boards of other companies. The second source of directors in Western countries is the faculty of business schools. Unfortunately, there are very few good business schools in Russia. The third source is the retired public servants; they actually work in boards of directors but this source is rather limited because turnover in Russian government is quite rare. Some companies invite foreign board members, but it is rather an exception than a rule. The key challenge for them is the language barrier and ignorance of the particular features of doing business in Russia.

Thirdly, the demand for independent directors is not as great as it might seem. Most private companies still have a controlling shareholder who owns a vertically or horizontally integrated group of companies. In these cases, a representative of the group in the board of directors cannot be, by definition, an independent director taking care of any particular company. State-owned companies come across similar problems: the officials who nominate board members in these companies are normally responsible for a wide range of economic policy issues and, thus, they often have a conflict of interests with respect to each company.

6.3. Boards of directors in Russia: practitioner's view[1]

My practical experience is general consistent with the theoretical and empirical arguments above.

First, boards of directors in Russian companies are rather heterogeneous. Some boards fully or almost fully comply with the international recommendations on corporate governance. There are also fictitious boards of directors that do not virtually hold meetings in person. There

1 In this Section, the author provides general arguments concerning the practice of boards of directors in Russian companies, which are derived from personal experience and the experience of his colleagues – independent members of Russian boards. For the sake of confidentiality, the author does not give any specific examples or names the companies that his arguments are based on.

are also boards where independent directors are not even aware of their fiduciary duty. Of course, it is related to the above mentioned issues. The history of the profession is very short, and reputational incentives just have not started to matter yet. Also, there is still a shortage of qualified independent directors. Therefore, career incentives do not work – the demand for independent directors still exceeds their supply. Furthermore, board members are not afraid of shareholders' lawsuits because they do not believe in competence and incorruptibility of the Russian judicial system. For this reason, fiduciary duty is not important either. Also, many boards of directors have been established and operate in full compliance with L. Bebchuk's 'pessimistic scenario'. Audit and remuneration committees are either missing or are controlled (sometimes even formally!) by the top management.

No wonder that many boards of directors failed to play an important role during the recent financial crisis. In a whole number of companies where the crisis uncovered drawbacks in the top management's operations, in particular, the obvious failure in risk management, the board of directors did not make the necessary decisions – either to replace the management or to reform the risk management system.

On the other hand, in some cases the boards took an active part in corporate governance during the crisis, by acting in full conformity with the best corporate governance practices, by promptly revising the budget and the strategy, by giving up remuneration or by shifting from a short-term compensation structure to a long-term one. Both before and after the crisis, all of the committees – on audit, remuneration and risk management – performed well in these boards.

In what way do the former boards differ from the latter? The effective boards are the ones where the number of independent directors, who understand their role and have a strong intrinsic motivation, forms a critical mass.[1] As noted above, so far neither reputational nor career nor

1 See, for example, Besley T. and Ghatak M. "Competition and Incentives with Motivated Agents." AMERICAN ECONOMIC REVIEW, 95 (3), 2005, pp. 616–636.

fiduciary incentives work in Russia. Therefore, it is the intrinsic motivation (i.e. the ambition to meet individual professional and ethical guidelines) that matters. It is quite understandable that no solution based on intrinsic motivation can be sustainable. Therefore, in order to improve boards of directors in Russian companies, one needs to undertake a number of specific measures, in particular the ones listed below.

6.4. What's to be done?

How can we improve the boards in Russian companies? Taking into account the inadequate quality of the judicial and regulatory systems, it is necessary, first and foremost, to rely on efforts of shareholders and companies themselves, rather than on the state; the research shows that it is not only necessary but also possible to raise the standards of corporate governance in individual companies.[1] Globalization and modern communications technologies enable improving transparency and addressing a whole number of coordination problems, by strengthening reputational and career incentives and also by introducing stricter requirements to independent directors' qualifications.

Firstly, shareholders should require that the corporations implement the best international practice in corporate governance standards, e.g. the UK Combined Code or the OECD Corporate Governance Principles. Obviously, these principles are not necessarily equally suitable to all Russian companies. However, corporations may use the conventional approach of 'comply or explain'. Companies themselves can choose what particular provisions of the code to apply and to explain why other provisions are not suitable to them. In this case, modern information technologies would enable to create an interactive platform for shareholders' discussion of which particular provisions the company should comply with and to what extent it implements the provisions it promised to implement.

1 Durnev A., and E. Han Kim E.H. "To Steal or Not to Steal: Firm Attributes, Legal Environment, and Valuation," JOURNAL OF FINANCE, 60, 2005, pp. 1461–1493.

Moreover, corporations themselves are interesting in creating such interactive platforms. If the top management and the board of directors do not create forums where corporate governance issues can be discussed, it means they are simply not interested in getting feedback on improving corporate governance. In this case, the mechanisms of sharing opinions and coordination of shareholders' actions will emerge anyway, because the costs of creating forums in social networks are virtually equal to zero nowadays. If a company facilitates creation of such discussion sites, it serves as a signal that it has nothing to conceal and is not afraid of greater transparency.

Secondly, it is necessary to make sure that independent directors' elections are transparent and competitive. According to the current Russian legislation, an independent director should be either nominated by the board itself or should obtain support from 2% of shareholders. It is, naturally, quite difficult to obtain 2% of voting shares in such major companies and banks as Gazprom, Sberbank, Rosneft, or VTB. On the other hand, as soon as 2% of shareholders nominate a worthy candidate supported by ISS/Riskmetrics, a majority of shareholders will vote for him/her. In this sense, the key problem is to nominate a truly independent candidate, which is quite a feasible objective – given the modern information technologies. Shareholders can easily conduct primaries online; in these primaries a candidate with the most promising platform will be able to obtain the necessary 2%. Again, if the top management and the board initiate the establishment of such site, it will be the best sign that the management and the board are interested in the better corporate governance and competitive elections.

Other issues are quite straightforward. For instance, it is important to carry out regular evaluations of the board itself. The board should, using a transparent procedure, hire external consultants to assess whether the board operates effectively and performs its fiduciary duties to shareholders. Also, the board needs to conduct regular non-executive sessions, i.e. meetings of independent directors in the absence of the management. The transparency of the board operations should be higher: the shareholders should

know the principles of determining the top management's remuneration, the board's procedures (including the process of creating the agenda and disclosing the conflict of interests) and the content of the minutes of the board meetings – as long as this does not contradict the privacy and trade secrets.

It is also necessary to hold mandatory secret votes on a certain range of issues, including the evaluation of top management, nomination of candidates for the top management and the board, etc. In principle, every board can make a decision as to holding a secret vote on any issue. However, in many boards most if not all votes are held in the open, to save time. The mere demand for a secret vote is perceived as a sign of mistrust. If secret votes on certain issues are mandatory, it protects the disagreeing independent directors automatically.

Another issue is the professional qualification standards for board members. For instance, CFA professional exam plays a key role for financial analysts, and ACCA exam, for accountants and auditors. A similar exam (CDir) exists for board members in the UK, it is held by the Institute of Directors, the 'trade union' of independent directors. Nowadays, when many independent members of Russian boards of directors do not simply know their powers and fiduciary duties, it is difficult to overestimate the role of professional education.

It is necessary to introduce board members' liability insurance. In its absence, fiduciary duty does not work: a director is afraid of lawsuits – nobody would sue against him/her because his/her personal assets are too insignificant to make up for the shareholders' losses.

A separate question is what is to be done with boards of directors in state-owned companies in Russia. There are two complementary answers. First, state-owned companies should become lead in terms of implementation of the best practices in corporate governance. Second, one should not think that a state-owned company can ever be run as well as a private company. No matter how hard we try to make state-owned companies to outperform the private companies in terms of corporate governance, this would be generally unlikely (even though exceptions to these rule are

possible and already exist). But the only comprehensive solution is full privatization of these companies.

On the other hand, whereas corporate governance drawbacks in state-owned companies may be explained by insufficient incentives due to the lack of an efficient owner, the question still remains: why aren't the above evident efforts taken in private companies? The available data provide a very simple answer. First, boards of directors in many Russian companies do not play a critical part so far, because the ownership is still concentrated and the majority shareholders' control remains the key corporate governance mechanism. As the ownership becomes more dispersed, boards of directors will play an increasingly important part. Second, the independent director's profession in Russia is still only in its infancy. There is still an acute shortage of independent directors; also the preconditions and mechanisms required for the effective functioning of the boards are just emerging.

Chapter VII

SHAREHOLDER ACTIVISM IN WESTERN EUROPE AND THE US: THE CASE OF SHAREHOLDER PROPOSALS AT ANNUAL GENERAL MEETINGS

Luc Renneboog[1]

7.1. Introduction

Shareholder activism can be placed on a continuum of responses that dissatisfied investors can give to corporate governance concerns.[2] At one extreme of the continuum, shareholders can simply vote with their feet by selling their shares while at the other extreme is the market for corporate control where investors initiate takeovers and buyouts to bring about fundamental corporate changes.[3]

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2 Gillan S.L. and Starks L.T., 'The evolution of shareholder activism in the United States', JOURNAL OF APPLIED CORPORATE FINANCE, vol. 19, 2007, pp. 55–73.

3 Parrino R., Sias R.W. and Starks L.T., 'Voting with their feet: institutional ownership changes around forced CEO turnover', JOURNAL OF FINANCIAL ECONOMICS, vol. 68, 2003, pp. 3–46; Martynova M. and Renneboog L., 'Spillover of corporate governance standards in cross-border mergers and acquisitions', JOURNAL OF CORPORATE FINANCE, vol. 14, 2008, pp. 200–223.