Oleg Shvyrkov, Ph.D, Director for Corporate Governance at Deloitte CIS; member of the Working Group on Establishment of the International Financial Center in the Russian Federation. **Corporate Governance in Russia in 2011: Old Problems and New Challengers. – 2012.**

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 companies to develop strong corporate governance practices. However, the weak legal and regulatory framework of corporate governance cause discounts on all Russian issuers, with even the most advanced companies being unable to fully eliminate the negative country effect and to overcome the inherent volatility of risky securities.

In the second part of this Chapter, we consider the example of Russian electric power generating companies and conclude that poor corporate governance infrastructure does not only impede the investment programs in individual companies but also limits the ability of the government to carry out a consistent industry policy. Gross violations of minority shareholders' rights in a number of generating companies undermined the reputation of the Russian market in general, while the misappropriation of funds resulted in a massive default on investment obligations by Russian private companies. For instance, according to our survey, less than 33% of the total heat generation capacity scheduled to be commissioned by the end of 2011 under the RAO UES of Russia's Program has been actually commissioned.

In the third part of the Chapter, the author presents an overview of the new initiatives for improving the legal background of corporate relations, which followed from President Dmitry Medvedev's call to improve the investment climate and modernize the economy. In particular, this section reviews the preliminary results of the new stage of legislative activity, which addresses many urgent problems of current regulation and involves an open dialogue with the

professional community. The same section addresses risks to implementation of these initiatives and their limitations.

The same section addresses the efforts of the government to strengthen corporate governance at companies under its control. Thus paper takes a positive view of the steps taken to enhance the role of independent directors' at state-owned companies, but also points at the controversy surrounding some of them, as well as some deeper problems of the government's objectives and philosophy regarding its controlled companies.

In the Conclusions section, we summarize the research compiled in the Chapter and the trends of the legal environment reforms.

1. Russian Companies on Equity Markets

In our opinion, the elapsed 2011 has not generally met the expectations, which were pinned on it, as concerns the Russian financial market. Besides the overall negative trends driven by the unfavorable global economic environment, the previous year suggested that funds raising on global equity capital markets is a difficult task for Russian companies. In addition to macro-economic risks, we believe that this phenomenon is due to the negative reputation of corporate governance in Russian companies. This is evidenced by both investor surveys and certain Russian IPO trends.

1.1. IPOs in 2011

In 2011, just ten companies held IPOs (vs 12 in 2010). These companies raised US$ 4.8 billion (vs US$ 5.3 billion in 2010); seven more companies held SPOs worth of the total of US$ 5.2 billion.[1] It is illustrative of the fact that the appetite for Russian assets was moderate: most IPOs were at the bottom price or at the forcedly discounted price. A number of Russian companies that declared their plans to hold IPOs in 2011 had to postpone IPOs due to slack demand.[2]

The adverse trends for shares of new IPOs during the year also give rise to concern, pointing to the lack of confidence in new issuers. In 2011, investors incurred losses from investments into nine out of ten IPOs and into six out of seven SPOs (the only exceptions were Polymetal Int and Magnit that carried out IPOs late in the year). Moreover, the yield of seven out

[1] "Shares to be Waited for". Anton Trifonov, *The Vedomosti*. December 28, 2011. Hereinafter, Alfa Bank's data (on placement prices) and information from stock exchange web sites is used in calculations.

[2] The mass media mentioned, inter alia, the aborted IPOs of SC Koks, Nord Gold, ChelPipe (ChTPZ), Evroset, Domodedovo, Vital, Vertolety Rossii, Valinor.

of ten IPOs and most of SPOs was below RTS; on average, Russian IPOs lagged behind the index by 8% (and all placements – by 5.8%) during the circulation period in 2011. Besides the above issuers, it was only Yandex and Global Ports (IPO), as well as Mail.ru and Armada (SPO), that managed to outstrip the index.

The activity of Russian companies in IPOs looks moderate against the background of BRIC peers countries: in 2010, Russia was dead last by the scope of funds raised at IPOs and most likely, came out last in 2011 as well. In a wider context of attracting portfolio investment, Russia has lagged behind its BRIC peers for many years (see Figure 1). This underrunning has become especially severe in recent years, with Russia being the only BRIC country with net outflow of portfolio investments in 2010.

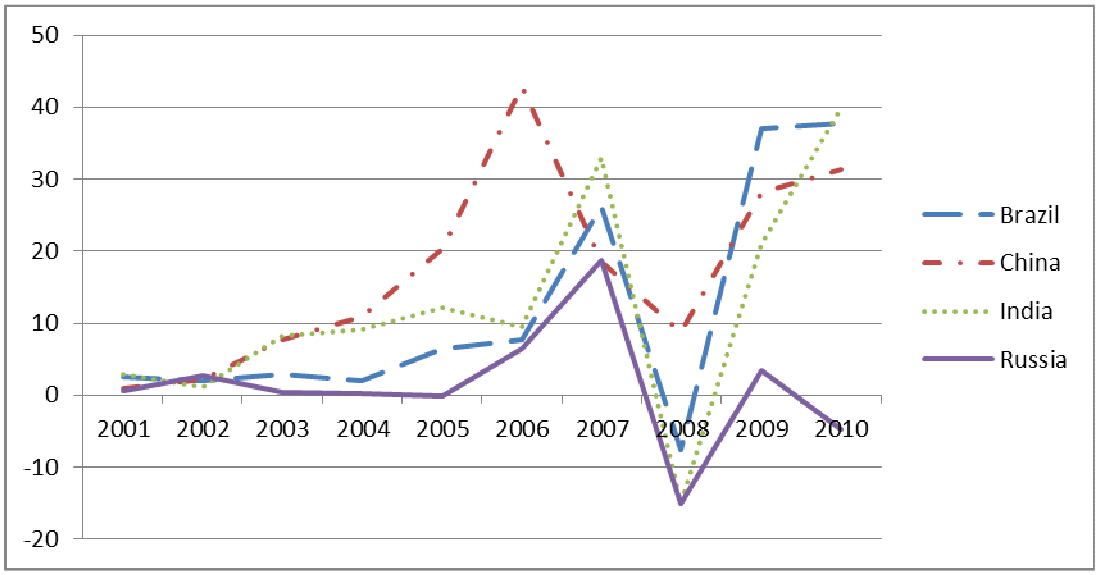


Fig. 1. Net Inflow of Portfolio Investments, in US$ billion (in 2010 prices)
Source: The World Bank

However, the Russian economy needs investments badly, due to its obsolete infrastructure, prevalence of capital-intensive industries in the economy, and its ambition for industry diversification. Over the two decades, Russia had substantial shortage of investments into fixed assets, outpacing Brazil only by this indicator in BRIC and almost double-lagging behind China (Figure 2). The State has limited options of funding the investment needs of the economy; moreover, against the background of the anticipated fiscal deficit period, many hopes are pinned on privatization income, which increases the significance of global capital markets for funding growth and for the modernization of the Russian economy.

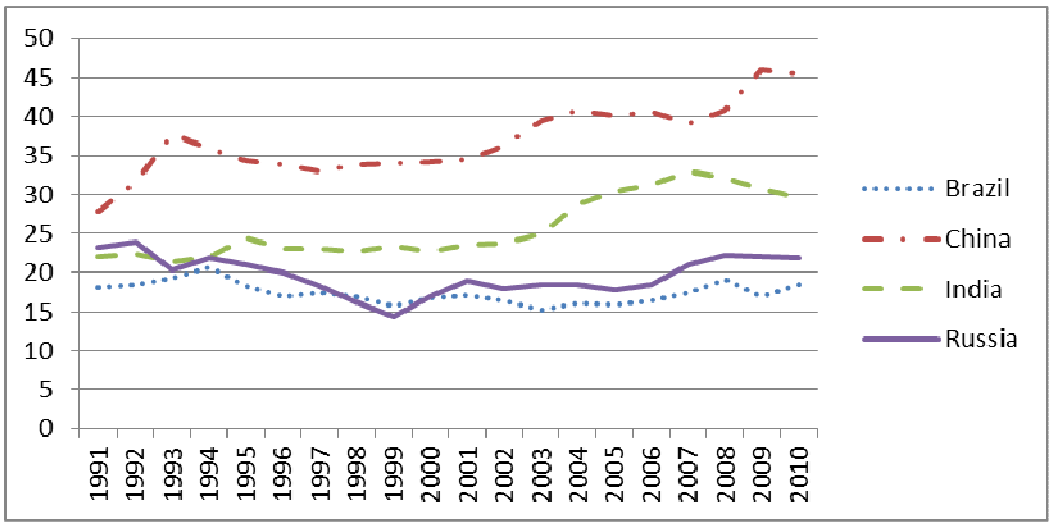


Fig. 2. Investments into Fixed Assets (% of GDP). *Source: The World Bank*

1.2. Corporate Governance and Capital Markets

In our opinion, the modest IPO volumes and the adverse trends for newly placed shares reflect, in no small part, the Russian market reputation in corporate governance, which is testified by both surveys of global investors (e.g. the study by Royal Bank of Scotland published in January 2010) and certain IPO trends. Many Russian companies spent the second half-year waiting for a 'window' for entering the capital markets; however, it is telling that the 'window' has opened for Magnit, twice awarded by the Investor Protection Association as a company with the best corporate governance in Russia (in 2009 and 2011), at the right time. Magnit raised US$ 475 million and, as noted above, its dynamics was much higher than RTS in the new issue circulation period. Another company that managed to place shares in 2H2011 was Polymetal Int. Having changed its jurisdiction in 2011, it undertook to comply with the corporate governance requirements envisaged in the U.K. premium listing. The company raised US$ 790 million and also showed the favorable quotation trends in the year.

Obviously, the consistent policy pursued by majority shareholders to introduce strong corporate governance structures brings its benefits in the form of favorable perception on financial markets. This is also testified by the example of Wimm-Bill-Dann Foods (WBD), a corporate governance leader in Russia, according to Standard & Poor's Governance Service: in 2011, PepsiCo. acquired 100% of WBD at an unprecedented valuation of over 16x EBITDA (2010).[3]

However, in the absence of efficient regulatory mechanisms for public companies, the difference in corporate standards would maintain the discount with respect to the entire market,

[3] "Milk at Oil Price". Irina Skrynnik, Elena Vinogradova, Aleksandra Kreknina. *The Vedomosti.* December 3, 2010.

and the efforts taken by individual companies cannot fully eliminate the country discount. According to Sergey Stepanov, Professor at the New Economics School[4], international academic studies concur that the average corporate governance level is inevitably lower in the countries with a weak legal infrastructure. It is partially due to the fact that the legal infrastructure weakness undermines investors' confidence in the efficiency of corporate governance tools, thus discouraging issuers from improvement. The effect of country discount becomes especially pronounced in the crisis environment and virtually erodes the reputational capital of individual companies.

It is also rather important that the perception of country risks for corporate governance determines not only the amount of discount required by global investors but also the prevailing type of the investment strategy with respect to Russian shares. The securities classified as highly risky ones are most severely affected by the phenomenon known as *flight to quality*: in the high market volatility period, many investors give up poor quality instruments, by transferring funds into high quality conservative papers. Therefore, highly risky issuers and markets where such issuers prevail are 'penalized' twice, i.e. not only by low valuation, but also by high volatility. Both phenomena pose major problems for national financial markets, preventing issuers from raising funds and also hindering the operations of national financial institutions, including superannuation and pension funds and insurance companies.

1.3. Conclusions

The specific features of Russian companies' IPOs on financial markets in 2011 suggest that, firstly, there is a major credibility gap with respect to Russian companies' prospects, which is largely determined by poor reputation in corporate governance. This influences both the amount of the country discount and the access to the equity capital markets, especially in the market volatility period. Secondly, individual issuers who managed to build up favorable reputation in corporate governance are capable of eliminating the country discount, to some extent, and have greater flexibility in raising shareholders' capital.

The perception of Russian companies as the ones described by high corporate governance risks results from the weak legal and regulatory infrastructure that allows significant difference among standards of different issuers and leaves the scope for gross violations of investor rights. The examples of the latter are available in the second part of this Chapter.

[4] Professor Sergey Stepanov's presentation at the annual conference of the Investor Protection Association, December 14, 2011.

The Russian market reputation in corporate governance creates major obstacles for raising funds by Russian companies, many of them are unable to implement large-scale investment programs without equity capital infusions. The same circumstance increases the volatility of the Russian financial market and hinders development of national financial institutions.

2. Reform experience at RAO UES of Russia OJSC: drawbacks of legal regulation of corporate relations as an obstacle to implementation of the industry policy and development of the financial markets

The reform of RAO UES and transfer of generating assets to new owners on the eve of the financial turmoil revealed the weakness of legal tools for regulation of corporate relations on the example of large-scale violations of minorities' rights during the change of control. In the companies where obligations to minority shareholders were fulfilled, the factors unrelated to Russian legal regulation and the standpoint of executive authorities on investors' rights played a major role.

The steps taken thereafter by a number of buyers for improper use of generating companies' funds suggested that the deficiencies in legal and securities regulation of corporate relations create difficulties not only for minority shareholders but also for the Government, in its aspiration to upgrade and extend the generating facilities: the plans to commission new facilities in 2008/2011, as worded by RAO EUS in 2008, have been fulfilled for less than one third. In the essence, minority shareholders and the State had the common interest in discouraging majority shareholders from channeling the company's resources towards meeting their own goals, thus breaching the investors' financial rights and obligations to industrial regulatory authorities. The difficulties in ensuring proper control over a company's assets as well as in legal protection of stakeholders clearly demonstrate the risks posed by the deficiencies in legal regulation of corporate relations and in enforcement for the efficiency of the state policy of industry reforms.

2.1 Mandatory bid

The provision as to the mandatory bid when a new major owner emerges or when the control changes, as worded for the first time in the British City Code in 1968, have been adopted in most jurisdictions, including emerging markets. The benefits of this provision for financial markets consist in application of the benefits from the control premium realization to all shareholders, which evens up the rights of different investor categories, in line with the logic of shareholders' relations, and also in mitigation of the risks related to speculative or opportunistic takeovers. In the jurisdictions where this provision has not been adopted (e.g. in 47 U.S. states),

the alternative market discipline tools, normally based on the liability of the shareholder who sells its controlling stake, apply.

However, even though there is a provision on the mandatory offer in Russian law, it was only exercised in 10 out of 18 generating companies[5] split off from RAO UES entities during the change in control in 2007/2008, with a major delay in one of the companies (TGK-14).

The legal arrangements that enabled buyers to avoid the mandatory bid were quite varied, ranging from the legally transparent (although economically questionable) regulatory waivers to plain exploitation by buyers of loopholes in Russian law and deficiencies in law enforcement. The first category of examples includes the waiver granted to Gazprom from such obligations in OGK-2 and OGK-6 and to SUEK, in TGK-12 and TGK-13; the second category of examples is the exotic interpretation of the Law on Foreign Investments into Strategic Companies, which was later upheld by courts (TGK-2 and TGK-4).

It is telling that not only private investors (Sintez Group in TGK-2, Onexim Group in TGK-4), but also government-owned companies (Gazprom in TGK-1 and Russian Railways in TGK-14) took part in the most disputable episodes of evasion from the mandatory bid.

The only category of investors that fully discharged their obligations under the mandatory bid were the international power companies (Germany's E.ON in OGK-4, Italy's Enel in OGK-5, and the Finnish Fortum in TGK-10), which were bound not only by the slack obligations under Russian law but also by business ethics and international reputational considerations.

In our opinion, the basic defects in Russian law as concerns the narrow definition of related parties give the opportunity for manipulations that undermine many positive provisions of Russian law. For instance, these defects enable one and the same financial and industrial group to formally act either as a national or as a foreign investor, depending on the benefits provided by the respective position. The same defects enable a major Russian investor to regard an actually affiliated company as a formally non-affiliated one and to hide the actual level of indirect participation in the public companies' capital.

In this respect, the attention paid to the related parties' problem in new draft laws (specified in a greater detail in the third part of this Chapter) as well as in chapter VIII of the National Report offers some hope. The law enforcement arrangements, which also distort the target-setting and the spirit of certain provisions due to limited resources and qualification of the judicial system, is a separate problem.

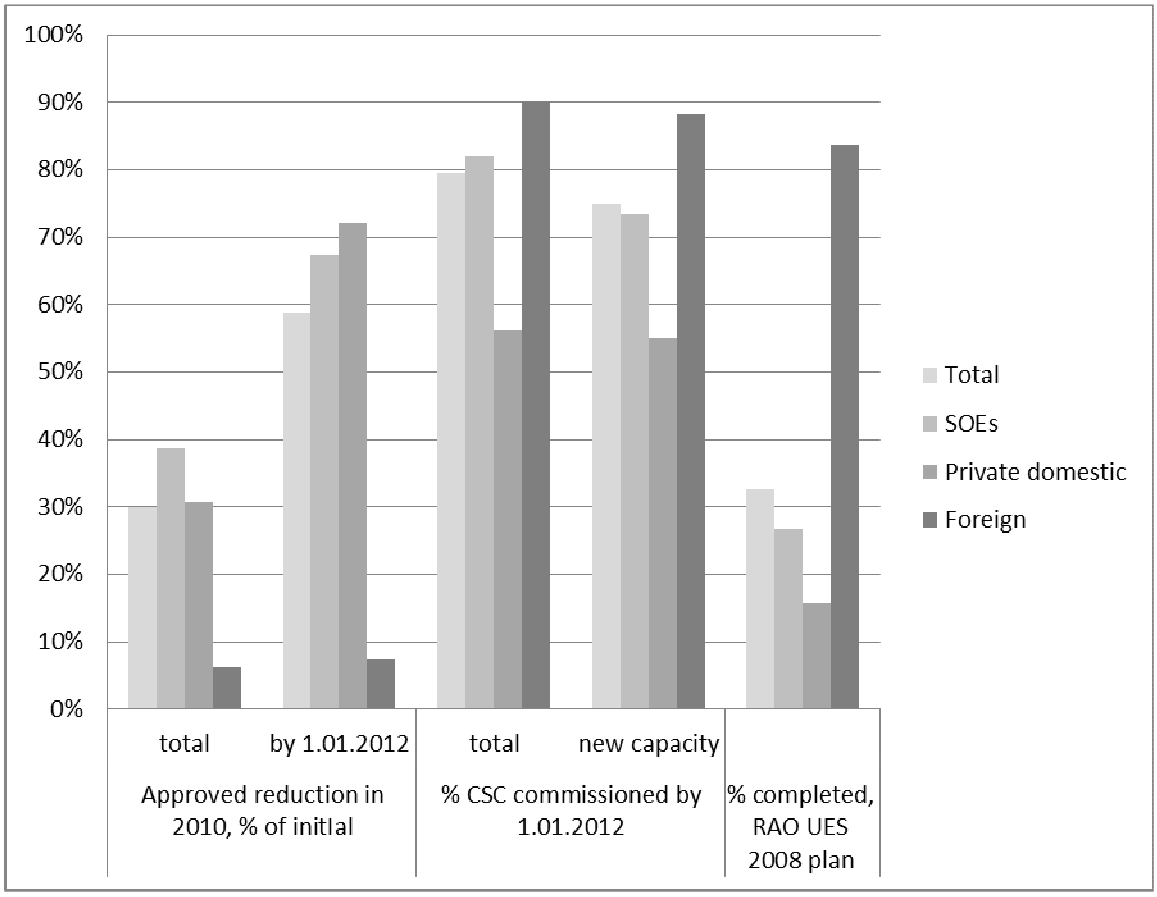
2.2. Investment Obligations

[5] Six wholesale generating companies (OGK) and 14 territorial generating companies (TGK). There was no change in control at two companies (OGK-1 and TGK-11).

Funds raising for upgrading and expanding the generating facilities was one of the key goals of the Russian power industry reform. During privatization, the generating companies raised funds from additional issues, but also undertook obligations under investment programs.

According to the plan approved by RAO UES's Management Board in April 2008,[6] twenty heat generating companies (6 OGKs and 14 TGKs) were tasked with commissioning of 42.4 GW of new and upgraded facilities by 2016, including 27.8 GW by January 1, 2012.[7] However, taking into account the economic turmoil, the Government agreed to reduce the total scope of investment programs to be implemented by these companies down to 29.6 GW (including 24.8 GW of new capacity) and to postpone the commissioning of a number of power units in 2010. According to the adjusted investment program,[8] these twenty companies were expected to introduce 11.4 GW, including 9.4 GW of new capacity, by January 1, 2012.

However, our study suggests that as of January 1, 2012, the actual capacity commissioning came to 9 GW, including 7 GW of new capacity (see Figure 3).



[6] List of Commissioned Heat Generating Facilities Included into the 2008/2012Consolidated Five-Year Program of Companies Formed as a Result of Reforming of RAO UES of Russia Holding OJSC. Approved by RAO UES of Russia's Management Board on March 17, 2008.

[7] We do not include the investment projects of INTER RAO UES OJSC, which had a special status during the reform, as well as the independent power unit construction projects, into our analysis.

[8] Russian Government Order of August 11, 2010, № 1334-r, On Approval of the List of Generating Facilities, Using Which the Capacity will be Supplied under Capacity Provision Contracts, as amended on October 5, 2010.

Fig. 3. Reduction and Implementation of the Investment Program, Broken Down by Ownership Type.
Sources: RAO UES Program of April 17, 2008, Governmental Order of August 11, 2010, № 1334-r, companies' and parent companies' websites (data on capacity commissioning).

Therefore, fulfillment of the capacity commissioning plan versus RAO UES's initial plans came to 32.7% as of the beginning of 2012. In our opinion, even taking into account the financial crisis, such a low outcome negatively characterizes the Government's ability to implement the industry policy consistently. The breakdown by the ownership type is of special interest, namely: the generating companies that remained in the indirect state ownership commissioned 26.8% of the capacity intended for commissioning by 2012, according to 2008 RAO UES plan; the generating companies being controlled by private Russian investors and the generating companies controlled by foreign power companies accounted for 15.6% and 83.7%, respectively. Foreign investors enabled the most successful implementation of the RAO UES' initial plans, and private Russian investors were the least successful in their implementation.

It is telling that the state-owned generating companies show rather high compliance with the timing of facilities commissioning under the adjusted investment program (the Capacity Supply Contract, or CSC), at 82%; however, they achieved the largest-scale reduction in the total scope of investment obligations in 2010, by 38.7%. Private Russian investors into the generating sector achieved a somewhat smaller (by 30.7%) reduction in the total scope of investment obligations; however, the compliance with the timing of facilities commissioning was inadequate: just 56.1% of the facilities intended for commissioning in 2008/2011 have been actually commissioned; as concerns new facilities, the share of timely commissioned facilities came to 54.9% by January 1, 2012.

As concerns foreign investors, the adjustment of the investment program was the minimal: just by 6.2%, and as concerns the commissioning by January 1, 2012, by 7.3%. One can presume that a smaller administrative resource available to foreign shareholders and the commitment to application of technical efficiency and reliability standards to Russian entities could have played their role. The compliance with the timing of investment project implementation as of January 1, 2012, in these companies was also the highest, 90.2% on CSCs, including 88.2% for new capacity.

As in the case of the mandatory bid at the change in control described in the previous section, the nature of implementation of the investment programs testifies to the weakness of regulatory arrangements in implementation of the industry policy. The Governmental generating goals are the most efficiently implemented by means of direct foreign investments, and the least efficiently, when assets are transferred to private Russian investors. The state-owned companies

occupy the intermediate position, displaying, on the one hand, a relatively high compliance with the timing of the project implementation and achieving, on the other, significant reductions in investment obligations.

The low investment compliance of Russian private companies, which are not directly influenced by the state as the shareholder or by the technical standards of foreign investors, gives rise to the greatest concern. In our opinion, the poor infrastructure of the corporate governance, which is intended to ensure targeted and sustainable use of corporate resources, is an important reason.

2.3. Improper Use of Funds

We did not seek to conduct a comprehensive assessment of the state of corporate governance in the industry; but even a superficial analysis identifies significant weaknesses in corporate governance practices in private generating companies. This is testified by numerous examples of improper use of the companies' resources, against the background of busy investment programs. For instance, OGK-3, which was an affiliate to Norilsk Nickel in 2007/2010, purchased a stake in RUSIA PETROLEUM in 2008 (25% - one share) for RUR 15.1 billion and 34.9% in the U.S.-based Plug Power for RUR 888 million, according to IFRS statements.[9] In October 2010, RUSIA Petroleum was announced bankrupt, and OGK-3 had to fully write off the investments into the company. Shares in Plug Power were partially sold on the public market in 2010, with the write-offs accounting for RUR 640 million (under IFRS). The Company was also involved in buying-in of shares in Norilsk Nickel from the market, having spent RUR 2.2 billion for these purposes in 2008 and RUR 209 million in 2009. These shares were sold with a profit to Norilsk Nickel Group in 2009; however, the company spent RUR 803 million again in 2010, to redeem shares in Norilsk Nickel from parent entities.

The example of OGK-3 is widely known on the market, due to the high profile of these transactions and the attention paid to them by investors and the Russian Government. However, there is every reason to believe that the situation at OGK-3 is, rather, a rule than an exception among private Russian generating companies. For instance, based on the findings of field audits, early in 2010 the Ministry of Energy sent the requests to OGK-3, TGK-2, TGK-4, TGK-5, TGK-6, TGK-7, TGK-9, TGK-12 and TGK-13 (i.e. to virtually all private Russian generating companies, except for the Yuzhnaya TGK-8, which is an affiliate of Lukoil) for repayment of the proceeds from additional issues, which were spent on improper projects. The summary of these requests is presented in Table 1.

[9] "OGK-3 Resolves to Sell 34.9% in Plug Power to a Wide Range of Investors". Anna Peretolchina. *The Vedomosti*, July 21, 2009.

Company	Major shareholder	Proceeds from additional issue, RUR billion	Improperly used funds (as of the beginning of 2010), RUR billion	% of additional issue
OGK-3	Norilsk Nickel	81.7	24.5	30
TGK-2	Sintez	9	1.2	13
TGK-4	Onexim	15.8	5	32
TGK-5	IES Holding	11.6	9.2	79
TGK-6	IES Holding	14.3	8.6	60
TGK-7 (Volzhskaya)	IES Holding	11	1.7	15
TGK-9	IES Holding	17	10.6	62
TGK-12 (Kuzbassenergo)	SUEK	7.5	5.2	69
TGK-13 (Eniseiskaya)	SUEK	6.3	1.2	19

Table 1. Improper use of proceeds from additional issues, as identified by audits conducted by the Ministry of Energy. *Source: "Shmatko's Ultimatum". Anna Peretolchina. The Vedomosti. March 24, 2010.*

So, the companies indicated in Table 1 diverted RUR 66.9 billion into improper projects by the beginning of 2010, or 38.4% on RUR 174.2 billion, which were raised during the additional issues. The most dramatic situation took shape in IES-Holding Group where 55.8% of the proceeds from the additional issue were spent other than for the purposes envisaged in the investment agreement.

Moreover, there are reasons to believe that, despite the Ministry of Energy's audits and the criticism on the part of the country's government, the things did not improve in 2010/2011. For instance, according to TGK-2 2010 IFRS statements, the company channeled RUR 2.6 billion towards purchase of Severneft Oil Company's debt liabilities and stated its intention to channel RUR 4.5 billion more in 2011 for these purposes. Also, in 2011, TGK-2 met with the criticism on the part of the Investor Protection Association, for preventing minority shareholders from exercising their voting rights and for the practice of non-transparent transactions involving fuel purchases from the supplier presumably related to the controlling shareholder.[10] We also feel uncomfortable by the fact that starting from 2008 four territorial generating companies affiliated with IES-Holding stopped publishing IFRS statements, which makes it difficult to independently analyze their financial transactions.

[10] Press Release of the Investor Protection Association of December 14, 2011.

2.4. Conclusions

The large-scale industry reform, which peaked in the generating companies' privatization and winding up of RAO UES of Russia in 2008, resulted from the consistent efforts taken by the holding's top management to raise investments and to shape the market competition in generation. However, whereas the previous stages of the holding's reconstruction had largely exemplified the transparency and the open dialogue with the investment community, the new owners' actions actually undermined the trust accumulated in the industry on the part of the investment community and uncovered more general problems of governing corporate relations and law enforcement. The discount on shares in Russian companies, as mentioned in the first part of this Chapter, partially indicates the gross violation of global investors' rights in the period of change in control in the generating companies and the subsequent practice of use of their resources in the interests of major shareholders.

It is rather important that, as concerns the efficiency of use of the funds raised during additional issues, interests of minority shareholders and the state coincided: the diversion of the funds to large owners' opportunistic projects was disadvantageous to both of them, and even more so, the withdrawal of assets. Therefore, the inefficiency of control over related party transactions as part of the applicable regulation, as well as of corporate officials' responsibility arrangements, set back the profitability of portfolio investors and hindered implementation of Governmental goals as part of the industry policy. Investors responded by increasing a discount on Russian papers, and the Government was forced to return to 'manual control' tools many times. Obviously, both trends do not meet the goals of the Russian economic upgrading.

3. New stage of corporate relations regulation reform: approaches and prospects

The multitude and topicality of the legal and regulatory infrastructure problems of corporate governance in Russia have been in the focus of the government bodies in recent years, which has been additionally facilitated by Russia's involvement in the G-20 work largely aimed at overcoming the global financial turmoil. Since 2010, within the framework of President Dmitry Medvedev's call for the investment climate improvement, the law-making in corporate relations and the operation of financial markets has become more active. We positively view the general direction of these efforts and the fact that starting from 2011 such work has comprised an open dialogue with the professional community as part of the Working Group on Establishment of the International Financial Center in the Russian Federation (IFC Group)., chaired by Alexander Voloshin, ex-Head of the Russian Presidential Administration.

Noting the new prospects for resolution of the acute legal regulation problems in corporate relations as part of the new law-making wave, we also point out risks for the new generation of legal initiatives. In our opinion, they consist, first of all, in the possible shifting of priorities against the background of the election cycle and, secondly, in the impossibility to resolve the law enforcement problems as part of the current initiatives.

Moreover, we note a number of efforts targeted at improving the state-owned companies' corporate governance practice, which were adopted on the initiative of President Dmitry Medvedev. These efforts focused on increasing the independent directors' role in the state-owned companies (SOEs) have been implemented consistently since 2008, being applied to the growing number of companies and reducing the number of the state representatives in their boards of directors. Despite the skepticism as to the applicable external directors' independency and professional reputation criteria, we believe that the search for ways to enhance efficiency of the state-owned companies' management testifies to the understanding by executive authorities of drawbacks in the existing model.

3.1. Initiative to Create an International Financial Center in the Russian Federation

The idea of establishing the infrastructure of a global financial center in Moscow was first voiced in 2008, as part of the Concept 2020. The Action Plan was defined at the Government level in 2009, and Alexander Voloshin was appointed the head of the working group, the composition of the project groups was determined and they began operation in 2010.

As part of the International Financial Center Group, they set up the Sub-group on Legal Regulation of Corporate Relations, chaired by Alexander Branis and authorized to analyze specialized law-making initiatives of ministries and state agencies at the stage of their agreement as well as to influence their promotion to some extent. Additionally, the Sub-Group worded a number of top-priority dimensions for development of its own initiatives towards improvement of the legal regulation in corporate relations.

The Sub-Group actively operated during 2011, holding weekly meetings. Apart from some particular results in the form of proposals on the bills, which are described below, this work enabled to improve the mutual understanding between governmental agencies' corporate governance specialists and professional community representatives (investors, issuers, practicing lawyers and advisors were invited to work in the Sub-Group). The lack of such dialogue had been felt for several years, from the time when the OECD and the International Financial Corporation corporate governance projects were completed in Russia.

At the start of its operations, the Sub-Group on Legal Regulation of Corporate Relations defined the fundamental principles of its work:[11]

- Protection of ownership rights.
- Protection of weak participants in legal relationships.
- Taking into account portfolio investors' interests.
- Improvement of corporate governance provisions.
- Non-downgrading of the current investor protection.
- Priority of preventive protection mechanisms.
- Easing up private corporate relations.
- Making use of global experience (of Germany, France, Brazil, Hong Kong, the U.S.A., the U.K. etc.).

Proceeding from these principles, members of the Sub-Group proposed and ranked, in terms of priority, the main directions of law-making.

- Transparency, investors' access to information.
- Responsibility.
- Affiliation.
- Shareholders' agreements.
- Quasi-treasury shares.
- Mandatory offer.
- Transactions.
- Board of Directors.
- Pre-emption.
- Reorganization.
- Assessment.
- Internal controls.
- Law-enforcement issues.

However, during the first year of operations, it became obvious that addressing of a number of topical corporate governance problems is also an objective of the bills simultaneously proposed by ministries and other government agencies. The Group management deemed it right to timely review the proposals and to uphold the functional initiatives of the Ministry of

[11] As concerns formal resolutions and plans of the Group, hereinafter Alexander Branis's presentation of December 14, 2011, is quoted.

Economic Development, the Ministry of Finance, and the Federal Financial Markets Service (FFMS). In particular, the Sub-Group considered and drafted comments and recommendations on the bills on public and non-public companies, mandatory offers, independent directors, and responsibility.

In addition, in relation to and independently from the bills proposed by government agencies, the Group reviewed the fundamental issues and drafted proposals on the first six modules of top-priority problems during the year. As part of the Transparency and Investors' Access to Information module, the Sub-Group developed a bill on information rights as well as the concept of disclosure of beneficiary owners. As part of the Responsibility module, the Sub-Group developed the definitions of 'control' and 'conflict of interests' that were not included into the applicable regulations, drew up amendments to the Draft Changes to the Civil Code and to the bill on responsibility of members of management bodies. The amendments to the Draft Changes to the Civil Code also covered the definition of 'affiliation' (the third module of top-priority problems), the functionality and the actual validity of shareholders' agreements (the fourth module), the criteria for classifying shares as treasury ones and for prohibiting voting on them (the fifth module).

As part of the sixth module of problems related to the mandatory offer, the Sub-Group drafted a number of proposals to supplement the FFMS's specialized bill, whereby it emphasized the determination of ownership thresholds, responsibility thresholds, as well as the enforcement efforts, the pricing procedure. The problems related to the Transactions module were reviewed but partially. As part of this module, they adopted a number of proposals on improvement of the legal regulation of the approval procedures for major transactions and related party transactions, in particular, with the view to reduce the workload on management bodies.

The Group plans to continue the dialogue for promotion of its own and joint initiatives, to review the following groups of issues that need to be resolved. The law enforcement issues are regarded as a separate set of problems. In this connection, the idea is to engage in a dialogue with the Supreme Arbitration Court in order to find solutions to the existing problems.

3.2. Search for New Governance Model in State-Owned Companies

The drawbacks of the vertical bureaucratic management model prevailing in state-owned companies, which took shape early in the 2000's, are known to the national government. It is evidenced by President Dmitry Medvedev's initiative to replace the officials in state-owned

companies' boards with independent directors and 'professional attorneys' in charge of agreement with the state of the standpoint on voting on certain strategic issues.

Switch from the model of filling board vacancies with representatives of the departments involved in the supervision over corporate operations and obliged to vote on the directives to the independent majority model meets, at least in general, the spirit and the letter of the Organization for Economic Cooperation and Development recommendations on corporate governance in state-owned companies. And even despite the disputable implementation aspects of this initiative (the state-owned companies' managers are often appointed as independent directors, and the relevance of experience is also often questionable), this policy, in our opinion, brought certain dividends, like some good appointments that leveled up, for instance, Svyazinvest's complicated reconstruction process.

In April 2011, President Dmitry Medvedev ordered to remove all high-ranking state officials (starting from the level of ministers, heads of agencies and services)[12] from boards of directors during 2011, which we see, from a practical point of view, as a disputable step that, however, testifies to the consistency of the Presidential course towards strengthening of corporate governance principles in state-owned companies.

We note that these efforts are not aimed at addressing the basic corporate relations problems in state-owned companies, such as unwillingness to delegate strategic decisions to the level of management bodies and willingness to use state-owned companies' resources for social and strategic objectives, the latter being inherited from the Soviet planned economy. Nonetheless, we hope that the new board composition would create the format and the motivation for addressing these issues.

3.3. Conclusions

The course towards economic modernization and development of the infrastructure of financial markets, as announced by President Dmitry Medvedev, gave an impetus to the law-making in regulation of corporate relations, by opening up new opportunities for addressing long-dated problems of the applicable regulation. Several expert groups in ministries and state agencies, which maintain a dialogue with representatives of the investment community, big businesses and the sphere of professional services, as invited to cooperate in the IFC Working Group, are involved in drafting new law-making initiatives.

[12] Russian Presidential Order of April 2, 2011, № Pr-846, List of Instructions to Take Top-Priority Efforts Aimed at Improving the Investment Climate in Russia

The main dimensions of law-making in 2011 included improvement of the disposition of corporate relations in non-public companies, increased transparency in public companies (in particular, transparency of beneficial ownership), specification of the notions of 'control', 'conflict of interests' and 'affiliation', enhancement of relevance of shareholders' agreements, and specification of the procedure for regulation of treasury and quasi-treasury shares.

These initiatives are quite righteously brought to the forefront, with the view of their potential practical significance. However, we note that so far the impact of the new initiatives on the practical regulation of corporate relations has been minimal, and there are no guarantees that their positive dynamics will continue in 2012, against the background of the electoral cycle. We also note that the existing initiatives can influence the law-enforcement practice to a limited extent.

Change in approaches to management of state-owned companies is also the sign of our time. Since 2008, the Government has been consistent in increasing the role of independent directors. Despite a number of disputable aspects in approaches to the board of directors composition in particular, to the applicable independence criteria, we regard this vector as a positive one, nonetheless. The openness of corporate procedures may become a starting point for addressing deeper contradictions related to the use of the state-owned companies' resources for social and strategic objectives of the state, contrary to the shareholders' interests.

4. Conclusion

The elapsed 2011 suggested that the drawbacks in legal regulation of corporate relations, in particular, as concerns law enforcement, becomes the most critical risk for sustainable development and reforming of the Russian economy. The problem of the infrastructure of corporate relations in Russia is realized by a majority of parties involved in them, from global investors to Russian authorities. But whereas the former translated understanding of the problem into selection of the conservative investment strategy, the Government and the law-makers need to take a much more complicated series of efforts.

The new wave of law-making, which has been observed since 2010, opens up the new opportunities; however, the ability to introduce actual improvements is not proven. So far, the practical results of these efforts are reduced to just two regulations – on the dividend payment procedure and on extension of the requirement to draft and publish IFRS statements to a wider range of companies (Consolidated Statements Law). More complex and profound elements of the legal reform, which pertain to the notion of related parties and control, have not yet been

implemented and meet with noticeable counteraction. Moreover, these efforts are not supported by reforms of the law-enforcement mechanisms.

A separate category of risks for the legal and regulatory environment reform of corporate governance is related, in our opinion, to footdragging in privatization processes. We believe that it is the withdrawal of the state from the capital of companies that can reduce the managerial burden on Russian authorities, thus releasing their resources for improvement of regulatory tools. At present, the imperfect industry and financial regulation tools are frequently substituted with the corporate influence channels and the ‘manual’ management, producing an adverse effect on the investment appeal of individual branches and the entire market.