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Measures to improve corporate governance

By Oganes Sarkisov,
Commercial specialist, U.S. Commercial Service, Moscow

Attracting foreign and domestic investment is a key issue of Russia's economic development. However, uncertainties in the system of corporate governance remain one of the major risks for foreign and domestic investors. The Russian government, the Federal Commission for the Securities Market, as well as public and private organizations, are increasing efforts to reduce risks for investors and imposing tighter responsibilities on issuers of corporate securities and their professional financial consultants. Companies investing in Russia must also be prepared to take individual measures to execute due diligence research prior to investing and take an active approach to participating in corporate governance once major investments have been made. There is a large number of business service resources to assist companies in minimizing risk before and after investing.

THE CORPORATE-GOVERNANCE ISSUE IN RUSSIA

"Corporate governance" (CG) is a relatively recent term which gained popularity in the late 1990s with the emergence of the global economy and major influential corporate players. It refers to how companies are managed, run and led and usually includes a core set of basic issues such as relations with shareholders, transparency and disclosure, board and management structure and process and ownership structure and influence. The movement to improve CG seeks to ensure that companies are well-managed and protect the legitimate rights of shareholders.

The fundamental problem of CG in Russia is the loss of shareholder equity of outside investors by insiders (managers and controlling shareholders) through different schemes of transfer pricing, asset stripping, dilution of capital, and poor disclosure of information. Some recent examples of corporate conflict and abuse of investor rights include:

- Sharp controversy among managers, minority share holders and government representatives over management's proposed plan to restructure the electric power monopoly Unified Energy Systems (RAO UES), which posed a strong danger of dilution of value for minority shareholders;
- Concerns about possible asset stripping and poor auditing in the relationship between Gazprom (the gas monopoly) and ITERA (a gas transmission and service company);
- The coexistence of competing boards of directors and management teams (Orsko-Khalilovski Metal Works);
- Sberbank, the state-owned savings bank, share issuance, which substantially diluted existing shareholder equity.

EFFORTS TO IMPROVE CORPORATE GOVERNANCE

Government-level efforts: The Russian government is becoming increasingly sensitive to the negative effects of corporate conflicts and abuses of investors' rights on the willingness of potential investors — domestic and foreign — to invest in the Russian economy. In order to improve market attractiveness to investors, the government has been supporting regulatory and legislative initiatives aimed at lessening risks for investors and imposing tighter responsibilities on issuers of corporate securities and their professional financial consultants. Recent amendments to the Criminal Code provide for criminal sentences of up to three years of jail for untimely information disclosure and misuse of insider information. The legislators are also developing a law which would increase responsibility for the quality of information disclosed by security issuers, consultants and dealers. The Federal Commission for the Securities Market (FCSM) also recently issued regulations intensifying its control in order to reduce risks resulting from financial intermediaries activities.

In response to investors' pressure, many major Russian companies are adopting their own corporate governance codes. So far, these moves have been voluntary.

At the same time, the Russian government recently realized that good corporate governance cannot be achieved solely through piecemeal legislation and regulations. Last year, the Russian government ordered FCSM to coordinate the development of a Corporate Governance Code, which would set broader principles of corporate governance and serve as a guide for all market participants including investors, security issuers, and financial intermediaries. The CG Code will introduce new standards for information disclosure, new rules of company listings, new documentation requirements and new standards of professional qualifications and ethics of board members. Experts from the Institute for Stock Market and Management, the Russian Institute of Directors and the Center for Capital Market Development are actively participating in the work on the Russian CG Code. Its authors are planning to submit a draft for governmental review by November 2001 and to complete the final product by March 2002.

Voluntary efforts by domestic companies: An important indication for Russian companies is the realization that well-managed companies are better able to raise capital. According to the Investor Opinion Study published by McKinsey & Co. in 2000, more than 80 percent of Russian investors say they would be prepared to pay more for shares of well-governed companies than for those of poorly-governed companies. Many Russian companies have received strong reinforcement when high corporate governance ratings have translated into successful stock offerings or adverse stories have led to sharp stock price declines. According to experts at a recent finance conference in Moscow, financial institutions are more readily inclined to lend to and offer better terms to companies with sound corporate governance.

In response to this realization, a number of major Russian companies are adopting their own CG codes. Sibneft was the first Russian company in 1998, followed by Lenenergo in 2000 and Yukos in 2001. All these companies took this action before offering their stocks in Western exchanges. Unified Energy Systems (RAO UES), LUKoil, Norilsk Nickel and other large corporations are in the process of developing their own CG codes.

International investors through non-profit organizations: Foundations are also promoting the improvement of corporate governance and investor rights. A leading example is the Institute of Corporate Law and Corporate Governance, which was formed in 2000 for the purpose of encouraging practical improvements in corporate governance. Its most notable project is the Corporate Governance Rating of Russian companies (CORE rating), which has rated 25 of the largest domestic companies (approximately 90 percent of market capitalization and nine out of 10 "blue chips"). The Institute also participates in drafting model legislation and evaluates government, legislative, and institutional initiatives to establish better corporate governance practices. It was founded with the support of major international investment groups including the European Bank for Reconstruction and Development (EBRD), International Finance Corporation, the Open Society Institute Foundation and U.S. investment group State Street Global Advisers. It accepts no individual support from Russian companies and operates from grants and income from its projects.

International organizations such as the U.S.-Russia Business Council and the American Chamber of Commerce in Russia are also very active in promoting corporate governance and business ethics events in Russia.

PROTECTING AGAINST CORPORATE GOVERNANCE RISKS

Russia offers attractive investment opportunities for investors who can minimize risk by gathering sound information and applying careful judgment. Investment banks and brokerage houses such as Troika Dialog and Brunswick Warburg offer their clients regular newsletters on corporate governance issues. They have developed their own corporate governance rating systems and can be a valuable source of information on CG issues for individual companies. Operating in all Russian local capital markets and providing formal advisory services, they have a team of expert financial specialists and strong relationships with Russia's leading corporations and financial institutions.

Ultimately, however, to effectively protect their interests, major investors in Russia may have to take a direct role in the corporate governance of the companies in which they invest. To participate effectively, companies must be ready to:

- Study company registration and bylaws;
- Study the company ownership and history for past corporate behavior;
- Use leverage inside of the company (seats on the board);
- Identify and involve allies inside the company;
- Use available legal remedies in Russian courts;
- Obtain favorable changes to company bylaws;
- Oppose illegal acts or pressure through publicity and seeking government intervention.

Fortunately, there are many well-established U.S. and international professional services - lawyers, accountants, due diligence investigators and security firms, which can effectively deal with Russian problems. Commercial Services offices can provide a list of such resources to U.S. companies that request it.

Hopefully, these new Russian laws and regulations, and a broader acceptance of good corporate government practices, will limit the need for direct interventions in the corporate governance process. At this moment, it appears that these developments are making Russia a less risky and more attractive place to invest. All companies thinking of investing in or selling to Russia should be aware of this trend.