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## INDEPENDENT DIRECTOR IN RUSSIA.

### NEW DIMENSION

In Russia, corporate governance remains one of the key issues in developing a civilized and efficient business environment. Established corporate governance practices by managers and controlling shareholders have not met international standards in many areas. Recent corporate governance recommendations, made within the framework of the 4th OECD/World Bank Corporate Governance Roundtable and the program "Corporate Governance Improvement in Russia", developed by the Federal Securities Commission of Russia (FSC), are aimed at enhancing the role of the Board of Directors in companies and maintaining the highest standards of professionalism by the members of the Board.

Indeed, now, almost a decade after the beginning of privatization, Russian corporate managers, strategic stake owners, portfolio investors and the government are all trying hard to bridge the gap in their perception of mutual rights and responsibilities. This has

coincided with a marked increase in the number of independent directors on corporate boards.

Now that the Russian capital market is becoming more developed, we have an opportunity to follow the best practices of including independent directors in the corporate governance system. To accomplish that, three things must be done: a professional community should be developed and educated; company



**Mark Jarvis and Alexander Ikonnikov**

managers and majority shareholders need to be convinced that independent directors can contribute value to companies, and the government and the

public at large must be informed of the benefits offered by independent representation on corporate boards to the economy and society as a whole.

The responsibilities of the Board of Directors and the role of independent directors will be outlined in the Russian Corporate Governance Code, a draft version of which is already being debated.

## INDEPENDENT DIRECTOR PROGRAM

The Independent Director Program was initiated by the Investor Protection Association (IPA) and Ernst & Young (CIS) Limited.

The Independent Director Program is intended to give a better understanding of the role and significance of independent directors through a wide range of targeted events, studies and publications which assist independent directors and those responsible for their appointment in keeping abreast of the best practices. The Program aims to introduce a new public institute, the profession of independent directors. The institute's mission will be to form efficient mechanisms of corporate governance and public control, and to raise the professional level and ethical standards of independent directors at Russian enterprises.

### Goals of the Program

The key objectives of the Independent Directors program are:

1. to develop and promote the best practice for independent non-executive directors
2. to create effective business communication for independent non-executive directors and those responsible for their appointment
3. to support and maintain professional growth of independent non-executive directors
4. to communicate corporate governance issues to the public.

## FIRST STEPS

On November 2, 2001, the Investor Protection Association (IPA) and Ernst & Young (CIS) Limited announced the launch of the joint Independent Director Program in Russia.



**Mattias Westman**

At the presentation to mark the launch of the Program in Russia, Mattias Westman, Fund Manager from Prosperity Capital Management, outlined the principal idea behind the project as follows: "Over the first several years, our primary concern was to try to shield ourselves from violations by Russian companies. While I cannot say that the violations have stopped altogether, the situation did change for the better, and dramatically so, and now

we are working to improve the operations of Russian companies and participate in their development".

Ivan Tyryshkin, President of RTS and independent director at OAO Sibneft, highlighted the vital importance of enhancing the professional skills of independent directors to ensure their efficient work on boards of Russian companies, saying he has no doubts that the joint IPA/Ernst & Young program will contribute to the improvement of corporate governance practices in Russia.



**Ivan Tyryshkin**

Alexander Ikonnikov, Director of the IPA, said:

"Effective independent non-executive directors can optimise board performance, making Russian companies attractive not only to its current shareholders but also to future investors. They should actively contribute to the success of an enterprise by bringing knowledge and experience to the board, whether in the context of the development of business strategy or on matters such as international markets, technology, shareholder relations or public affairs.

Stephen Moosbrugger, Managing Partner of Ernst & Young (CIS), said:

"We have seen many initiatives recently on the subject of corporate governance led by the excellent Corporate Governance Code issued by the Federal Securities Commission which we support wholeheartedly. The launch of today's Independent Director Program is a supporting initiative to such work and is a program we can add immense value to given our work in the UK with the Institute of Directors."

Mark Jarvis, Managing Director for Corporate at Ernst & Young, emphasized that "the best non-executive independent directors have a breadth of view that complements the necessary focus of executive directors involved in the day-to-day running of the business. They are experienced, prepared to challenge the accepted wisdom, and today Ernst & Young and the IPA launch this program to develop these ideals in Russia".

### BUSINESS LUNCH AT MARRIOTT AURORA

On November 1, 2001, the IPA, Ernst & Young, the UK-Russian Chamber of Commerce and The Moscow Times hosted a business lunch to discuss the role of independent directors at companies, focusing on the future development of the institute of independent directors and the indispensable qualities of independent directors.

Speakers included Mark Jarvis, Ernst & Young's Corporate Finance

Managing Director; Dmitry Vasilyev, Chairman of the IPA Board of Directors; Alexander Kolesnikov, member of the Board of RAO UES of Russia; Alexander Ikonnikov, IPA Executive Director; Yevgeny Yasin, independent director at Vimpelcom; Michael Tappan, Chairman of the Board of Ward Howell International; and Juan Cavalier, Ward Howell International's Chief Expert.

Independent directors are quite a novel concept on the Russian market, whereas in Europe and the US the nomination of independent directors to corporate boards is a common practice. Hence, breakfast discussions focused on an analysis of the independent directors' roles and functions at companies, based on Western experience and the fledgling Russian practice in the area.

Mark Jarvis (Ernst & Young) highlighted the fact that the Independent Directors Program is part of a broader international effort sponsored by Ernst & Young in conjunction with the Institute of Directors in the UK and with the IPA in Russia, and

is designed to facilitate improvements in corporate governance culture. Along with and in addition to the Corporate Governance Code being developed by the Federal Securities Commission in Russia, the IPA and Ernst & Young's initiative to institute and develop the institute of independent directors in Russia will benefit the businesses and society as a whole rather than separate individual shareholders. The Program will complement the existing IPA practice of nominating shareholders' representatives for inclusion in the boards of Russian enterprises. Mr. Jarvis mentioned that in 2001 alone 23 independent directors proposed by the IPA were made members of the board at 38 Russian companies.

In his presentation, IPA Chairman of the Board Dmitry Vasilyev emphasized that the concept of independent directors should be viewed separately from that of minority shareholders' representatives who are nominated for inclusion in corporate boards through vote consolidation.



Dmitry Vasilyev

Companies aspiring to present themselves as truly public companies must have both minority shareholders and independent directors represented on the board. In addition, as Mr. Vasilyev believes, there is a need to alter the attitude of corporate CEOs, who ought to willingly engage independent professionals who can act as mediators in situations where dis-

parate shareholder groups defend differing opinions and antipodal proposals. To accomplish this, Mr. Vasilyev suggests that shareholders agree to voluntarily delegate a portion of their votes to elect an independent director. In such cases, the candidate should be acceptable to everyone and will be merited on his/her professional qualities and reputation. "A rating of Russian companies by the Institute of Corporate Governance showed that the companies with independent directors are better off in terms of the quality of corporate governance", added Mr. Vasilyev. Several Russian corporations, mindful of their good corporate image, have already undertaken this effort by incorporating the relevant provision into their charters.

A distinguishing characteristic of an independent director is his/her independence of the controlling shareholder,

the management of the company and the government. In the opinion of Alexander Kolesnikov, member of the Board of RAO UES of

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Russia, "there is no such thing as an ideal independent director. Minority shareholders represent specific legal entities with quite definite business interests". Even so, Mr. Kolesnikov believes that if at a given point in time and in a given place an independent director represents the interests of the company and its shareholders in general, he/she may be regarded as being independent. In 2001, an IPA director, David Herne, was added to the Board of RAO UES of Russia. Mr. Herne, who among other things represents the interests of the company's minority shareholders, has already demonstrated some tangible deliverables. Most recently, Mr. Herne became head of the Energy Sector Reform Committee established at the company in September 2001. As an independent director, Mr. Herne is responsible for securing an appropriate balance of interests between the various groups of shareholders, and for the protection of their rights during the restructuring of the sector.



Alexander Kolesnikov

According to Mr. Kolesnikov, unfortunately there is no readily available market for independent directors in Russia yet. Like any other professionals, independent directors need to be educated and trained, possibly at specialized business management schools. Matters that should fall within their authority include compliance, industry knowledge and business management issues. Yevgeny Yasin shared his views and experience as an

## LEGISLATIVE DEVELOPMENTS

The current draft Corporate Governance Code incorporates a section on the nomination of independent directors when electing the Board of Directors. This provision would increase the efficiency of corporate Boards. Independent directors are needed for an objective assessment of the work of the executive bodies of a company and the adoption of substantiated decisions on matters where the interests of the CEO and the members of the Board and those of shareholders may diverge.

The Code also states that independent directors must constitute at least 25% of the Board so as to have a realistic opportunity to leverage the decisions taken. This is a prior condition if independent directors are to contribute to a wide range of opinions on the issues discussed. In any case, a Board of Directors should include at least three independent directors.

Special consideration is given to preserving the independence of 'independent' directors. An independent director should refrain from any actions that may make him or her lose independence. If there are any changes or circumstances following the nomination of an independent director to the Board of Directors which result in the loss by this director of his or her independence, such a director must file a notice with the Board specifying such changes and circumstances. In such cases and also in cases where the Board of Directors learns otherwise of the above changes or circumstances, the Board is obliged to notify the shareholders accordingly and, if necessary, convene an extraordinary general meeting of shareholders to elect a new Board of Directors.

independent director on the Board of Vimpelcom. Mr. Yasin highlighted three issues that independent directors should focus on: their reputation as independent directors; interaction with different shareholder groups, and relations between the business community and the government. As vividly described by Mr. Yasin, "an independent director is God's envoy to the company", and his/her reputation is the principal warranty of his objectivity. When there are no minority shareholder representatives on the Board, it is the duty of the independent director to protect their interests. The role of the independent director is to find a balance of interests between various shareholder groups and resolve strategic planning issues. Mr. Yasin also spoke of his experience as part of the Board of Vimpelcom. Invited to join the Board by co-founder Dmitry Zimin, he nonetheless chose to represent the interests of the company in general, consistently calling for strategic investor search and focusing the Board on gaining a wider market share, which required considerable investments and profit capitalization.

According to Michael Tappan, Chairman of the Board of Ward Howell International, the nomination of independent directors to corporate boards is a fairly common global practice. For example, in the US 78% of the Boards of Directors have "external" members, and 21% of these are women. Professionally, the breakdown is as follows: 53% are current executives of other companies, 9% are former executives, and 38% represent other categories (according to Ward Howell International). The role of external directors is to monitor the



**Juan P. Cavelier and Michael A. Tappan**

efficiency of the top management and the company in general, assist the management in adopting strategic decisions for the benefit of the company, and be a substitute for top managers in critical circumstances.

Alexander Ikonnikov outlined the initial results of the Independent Directors Program, emphasizing that the IPA has already commenced ongoing consultations with Russian and foreign investors to nominate independent directors to the Boards of Directors of Russian companies for the next year. Program agenda for 2001 includes a series of research efforts to study the role and significance of corporate Boards and draw up a list of independent director candidates. The joint initiative will be headed by Mr. Alexander Filatov, PhD in Economics.



**Alexander Filatov**

The implementation of the Program requires joint efforts on the part of government bodies, securities market players and other representatives of the business community. The seminar was attended by Russian and foreign investors and issuers, representatives of international financial agencies, major consulting firms, public organizations and the academic community.

## QUESTIONNAIRE

Full name \_\_\_\_\_

Position \_\_\_\_\_

Contact phone number \_\_\_\_\_

E-mail \_\_\_\_\_

Mailing address \_\_\_\_\_

### How well are you familiar with the Institute of Independent Directors program?

- Don't know anything about it
- Heard a little about it
- Quite well familiar with it
- Monitor its progress

### What activities as part of the Institute of Independent Directors program would you be interested in?

- Seminars/conferences
- Business breakfasts
- Publications
- Working groups
- Round tables
- Sociological surveys

## SURVEY

*This survey is part of the Independent Directors program. The results of the survey will be published in the forthcoming issues of the newsletter.*

### Please specify your company's focus

- Trade
- Finance
- Construction
- Audit
- Other \_\_\_\_\_

### What do you think of the possible inclusion of an independent director in your Board of Directors?

- I believe that our company needs an independent director
- Prepared to consider such a possibility
- Skeptical
- Our company has no need for an independent director
- I am not familiar with the Independent Directors Program and don't know if an independent director would be useful

### What matters, in your opinion, should be within the authority of independent directors?

- Corporate strategy
- Financial plan
- Dividends policy
- Marketing
- Operations
- Investments
- Long-term borrowings
- Operational and financial management improvement
- Public relations, relations with shareholders, potential investors
- Other \_\_\_\_\_

**Select the independence requirements for independent directors (multiple answers allowed)**

- Cannot represent the government
- Cannot be dependent in any way on the majority shareholder
- Cannot be dependent on the company management
- May represent the government
- May be related to the majority shareholder
- May be related to the executive management

**Do you think there should be specialized training programs for independent directors?**

- Yes
- No
- Don't know

**Do you think independent directors should undergo additional training in the form of a company-specific orientation program when assuming office?**

- Absolutely
- Not necessarily
- No
- Don't know

**What documents should regulate the activities of independent directors?**

- Corporate charter
- Company by-laws regulating the Board of Directors' proceedings
- Corporate Governance Code
- None
- Other (please specify) \_\_\_\_\_

**Does your company have or did it have independent directors on its Board of Directors?**

- Yes
- No

*If you answered YES, proceed to the next question, and if the answer is NO, skip the next question.*

**Please provide basic information on an independent member of the Board of Directors at your organization:**

Full name

Contact phone

Term in office

Nominated by:

- controlling/majority shareholder
- executive management
- minority shareholders

*(specify corporate shareholder or organization representing the interests of multiple shareholders)*

**Please list three issues relating to the nomination and activities of independent directors that concern you most:** \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

**Thank you for participating in our survey!**

## **INDEPENDENT DIRECTORS NOMINATION PRACTICE IN 2001**

Compared to last year, corporate attitude to the nomination of independent directors has changed significantly, along with changes in independent directors as such. According to IPA representatives, managers are beginning to regard independent directors as allies.

Compared to 2000, the number of independent directors has increased due to growing support on the part of company managers and majority shareholders who have given some of their votes for independent directors.

All companies may be broken down into three groups: those whose minority shareholders had a sufficient number of votes to put their representatives on the Board; companies whose minority shareholders had just enough votes to nominate candidates, and companies with minority shareholders who could only hope for the management's good will. Actually, the management accommodated the shareholders in many instances. For example, OAO United Heavy Engineering Plants ceded 22% of ADR votes to the IPA. The management of Sibneft was equally responsive to IPA pleas, voting in an independent director.

In 2001, 23 independent directors proposed by the IPA were made members of the board at 38 Russian companies. The actual number of independent directors is even larger, as many nominations bypassed the IPA.

Most companies with independent directors are now paying dividends on time and develop in-house codes of corporate governance and programs to increase shareholder value.

## **THE ROLE OF AN INDEPENDENT DIRECTOR IN A COMPANY**

It may appear that the principal role of independent directors is to represent minority shareholders. In international practice, however, shareholder protection is but one of their primary tasks, although it is the minority holders who are most interested in having an independent member on the Board.

A candidate should be acceptable to all parties, i.e. enjoy the trust and respect of both shareholders and managers. Russia has already gained some experience in independ-

ent director nominations, which is available for examination in a survey conducted by the IPA in conjunction with the Association of Managers in 2000-2001.

On the whole, company managers and investors see major benefits in having independent directors on corporate boards, while also noting that they do not impede the operation of the Board as a collective authority.

Mention should be made of the issue of 'transparency' and the improvement of the corporate image, the importance of which for both management and investors should not be underestimated, as it allows managers to solidify the company's presence on the market and secure investor and business partner trust, indirectly contributing to the inflow of capital, and enables investors to safeguard their rights. Corporate managers and investors alike believe that independent directors can ensure greater objectivity of information on corporate activities and help build a positive image of a business.

However, company managers and investors do not always share the same views as to the role of independent directors. Managers tend to see independent directors as professionals capable of contributing positive ideas and suggestions to corporate operations, while investors are far less inclined to regard independent directors as strategists, instead assigning them the role of control over the management's actions.

This divergence demonstrates that each party is apt to see independent directors as guardians of its own interests. This is positive confirmation of the fact that neither investors nor corporate managers are hostile to the notion of independent directors, which is extremely important for further development of the institute of independent directors and the practice of independent director nominations.

If you would like to receive regular updates on the Independent Directors program, please fill out the questionnaire below. You can submit our questionnaire using an enclosed return envelope or send it by fax (095) 938 6675.

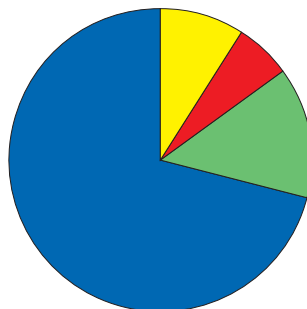
Also, you can complete and submit it in electronic form at [www.corp-gov.ru](http://www.corp-gov.ru).

For additional information, please contact Olga Tarilova at (095) 938 6651.

## Who is an Independent Director Independent of?

According to a survey undertaken by the IPA, a distinguishing feature of independent directors is their independence of the controlling shareholder, the company management and the government, i.e. an independent director cannot represent the government or be financially or otherwise dependent on the majority shareholder and/or the executive management of a company. Most of the independent directors met this qualification; however, 9%, 6% and 14% did effectively represent the majority shareholder, the government and the executive management, respectively.

On the whole, the issue of independence is more critical for investors, because they represent the interests of the mistreated party and make stricter demands on the qualities of their representatives. From the investors' standpoint, a mandatory criterion of independence is that a member of the Board of Directors cannot be in any way related to the controlling shareholder (holding a blocking interest) and the executive management of a company.



- **71% - qualification of independent director**
- **9% - represent the majority shareholder**
- **6% - represent the government**
- **14% - represent the executive management**

## WESTERN EXPERIENCE: Hidden Traps

A survey by the UK Institute of Directors has shown that despite the growing percentage of independent members on corporate boards, most of them are unable to receive the appropriate professional training or orientation required for work in a given company. Survey results show that the average number of independent directors on corporate boards has already exceeded the recommended level (a minimum of one third of total membership) at both public and private companies, even though the latter are not obliged by law to have a Board of Directors, but may do so at their own discretion.

At present, UK companies have an average of 40% of independent directors on their boards, with the remaining 60% representing the executive management.

On the other hand, according to the survey, as much as 53% of independent directors were unable to receive any orientation training following nomination, and only a mere 14% had the opportunity to undergo additional professional training that they needed for working at a new company.

The survey also showed that only 38% of independent directors enjoyed the necessary information and advisory assistance while in office.