INDEPENDENT DIRECTORS ASSOCIATION

Independent Director

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INVESTOR PROTECTION ASSOCIATION

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New Tendencies in the Election of Independent and Outside Directors in Russia

Meeting of independent director Mr Seppo Remes with members of Independent Directors Association

The following is a summary of the Independent Directors Association (IDA) election results regarding the Boards of Directors of Russian companies in 2003.

In comparison with the years 2000 through 2002, this year's nominating and electing tendencies of independent directors changed substantially. The new trend is for many actors to share the interest in the nomination of independent directors, from minority shareholders to companies themselves, and their majority and strategic investors. This can be chiefly explained by the fact that companies perceive additional value in the form of increased investment attractiveness and capitalization growth.

There was also the introduction of more stringent requirements at the New York Stock Exchange. A new and mandatory listing prerequisite is the availability of audit committees consisting exclusively of independent directors in the companies' boards. Further, reduced representation of independent directors nominated and supported by the Investor Protection Association has been caused by a tightening of the definition of "independent director" according to the Russia Corporate Governance Code and international best practice.

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Legal Responsibility of Directors

I.L. Ivanov,
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Building a balanced system of responsibility of members of management bodies (directors) in Russian companies has long been discussed as one of the critical issues in the corporate governance reform. But as experts have noted lately, there is every reason to anticipate an "era of claims" to directors. When such an era comes many companies and managers will face the legal and financial problems, known mostly from the American or European practice.

The growing competition and desire to improve the companies' investment attractiveness make the market players develop more precise criteria of directors' performance and ensure the improvement of their professional behavior standards. In its turn, the latest trends in legal regulation, the spread of up-to-date corporate governance practices, and particularly the ongoing development of the independent directors institution lay the ground for the establishment of the rules of legal responsibility of corporate directors. *

Risk factors

In evaluating the existing and potential risks in each specific situation, it is important to acknowledge that the possibility of claims to directors increases with the growing publicity of the company in case of attracting foreign portfolio investments through the issue of depositary receipts, listing at foreign stock exchanges, etc. Other liability risks are related to the post-privatization ownership structure and arise out of shareholders' conflicts, or from changes of ownership, including those through mergers and acquisitions.

The typical breaches resulting in the director liability include, for example, transactions executed in the director's own interests, competition with the company, disclosure of confidential information, inclusion of invalid or misleading data in the issue prospectus, lack of control over financial operations, misestimate of the transaction price, fraudulent bankruptcy, violation of antimonopoly or other laws, lack of control by the corporate governance body over the activities of other directors.

Basis of liability

The RF Civil Code and Federal Laws «On Joint Stock Companies» and «On Limited Liability Companies» regulate civil responsibility of directors in respect of the company. They provide for damages to be paid by the director to compensate for losses incurred due to his culpable actions (failure to act). Directors who caused such losses collectively, for example, if they voted for a decision, which led to losses, bear joint liability. Claim can be issued either by the company's executive board, or by any shareholder or shareholders who own jointly at least one percent of outstanding ordinary shares (in the interests of a public company), or by any member (in the interests of a limited liability company).

In practice in order to enforce the liability rules it is critical to find out if the director's actions were culpable, i.e. whether the director demonstrated an adequate level of care and prudence. The criteria of adequate behavior is the legal principle, that directors should act in the interests of the company, reasonably and in good faith in exercising their rights and fulfilling their responsibilities.

According to this principle the company's interest can be generally defined as long-term commercial success based on stability, profitability and efficiency. Nevertheless, sometimes a transaction seemingly intended to yield profit runs counter to the corporate interests (e.g. when risks exceed the reasonable level). The principle also presupposes loyalty to the company, i.e., the director should not privately benefit from the company's commercial chances. For example, if the director knows about the possibility to execute a contract on favorable conditions in the interests of the company, he should not use such information for joining such contract either as an individual or through a related firm. The loyalty requirement also includes the director's responsibility to keep commercial secrets and refrain from divulging any other information if such disclosure contradicts the company interests.

Director's honesty and reasonableness also presuppose that he dedicates all his abilities, knowledge and expertise for the company benefit and is able to understand if his business qualities are sufficient for adequate execution of management or supervision his functions. Wrong self-esteem, lack of knowledge or expertise or failure to consult experts when it is required for well-informed decision-making, should not release the director from responsibility. Director's actions are considered reasonable if they are based on successful business practices and on decisions, which do not involve excessive risks

* *The article deals only with the civil responsibility of directors, not criminal or administrative responsibility.*

for the company. Yet reasonableness does not exclude normal business risk, therefore, director's responsibility does not directly depend on the success or failure of business operations.

The most risky in terms of director's liability are the situations that involve conflict of interests, in particular, in case of membership in the boards of several companies. In order to protect the company interests efficiently and at the same time define the specific responsibility of each director, legal advice should be asked even before the emergence of any disputes. For example, director liability issues should be regulated in detail both in the internal corporate documents and in individual contracts with directors.

Specific grounds of direct liability of directors in respect of third parties are established, first of all, in the Federal Laws "On Protection of Rights and Legal Interests of Investors on the Stock Market", "On Insolvency (Bankruptcy)" and "On Bankruptcy of Credit Institutions". For example, the director who signed an issue prospectus bears subsidiary liability with other signatories for the losses incurred by the investor due to invalid or misleading information included in such issue prospectus. Subsidiary liability of directors in respect of creditors arises in case of intentional bankruptcy, breach of the bankruptcy laws and on some other grounds.

Publications on these matters repeatedly note the need to expand the legal regulations and envisage new specific grounds of director's liability with respect to shareholders (members), creditors and other third parties. The practice of some Western jurisdictions suggests the development of an expanded list of such grounds in Russian law in the nearest future.

Insurance and compensation

The company can protect directors acting in the company interests against liability to third parties. The most effective method is insurance of director liability, which is rapidly developing in Russia. The main conditions of such insurance or terms of indemnification should be specified in the corporate internal documents and in contracts with directors. Indemnification can also include litigation expenses including reasonable lawyer fees.

Deciding the issue of insurance of director liability or payment of indemnification one should bear in mind that breach of director obligations to the company does not necessarily result in losses, moreover, economic losses do not always presuppose such breach. But when the director violates the principle of prudence and reasonableness the company should by no means provide him financial protection.

New Tendencies in the Election of Independent Directors in Russia (continued)

Twenty-one out of ninety-four IDA members became independent directors in 29 companies according to the results of 2003 annual shareholders' meetings. Another 8 Association members were elected to represent minority interests in 15 companies. A number of IDA members were nominated and elected with the support of the Investor Protection Association. Sixteen members were supported by major shareholders and by strategic investors to the Boards of more than 30 companies. Currently, the majority of Association members are members of the Boards of Directors and/or executive directors of Russian companies. IDA members became independent directors in such companies as North-Western Telecom, CenterTelecom, Apteka-Holding, GUM Trading House, Nornickel, Wimm-Bill-Dann, Echo of Moscow, Votkynsk Hydroelectric Power Station, Kalugaenergo, Kurganenergo, Permenergo, and Stavropol State Regional Power Station, among others. IDA members represent minority shareholders in such companies as OMZ, Astrakhanenergo, Konakovo State Regional Power Station, and Smolenskenergo, to name a few.

Regarding the difference between an "independent director" and a "representative of a minority shareholder:"

In IDA's opinion, a member of the Board may be an independent director in a company provided he complies with the independence criteria established by the Code of Corporate Conduct as developed by the Federal Securities Market Commission and with additional requirements of the Code of Independent Director adopted by the Association. In such case, an independent director may be nominated and elected by the votes of the company's controlling shareholder, by a minority shareholder, or by a group of shareholders. An independent director works for the benefit of the company and in the interests of all shareholders. A representative of a minority shareholder represents the interests of the specific shareholder who ensured his election into the Board of Directors.

Board of Directors in Public Company Management System

Arkady Nesterkin, Head of Corporate Finance and Investment programs, Interfin Trade, member of IDA.

The highest management body of a public company is the annual shareholder meeting. Shareholders have the right to make critical decisions, which determine the activities of a public company. But the general shareholders' meeting is not a standing management body. As a rule, it convenes once a year (except extraordinary meetings).

Its executive bodies perform current management of the company. Executive bodies report to the Board of Directors and the general meeting of shareholders.

The role of the Board of Directors is to ensure the general management of the company. For this purpose the Board is assigned wide managerial powers. At the same time the Board does not replace the highest management body and is not entitled to resolve the issues falling under the jurisdiction of the annual shareholders meeting.

Therefore, the Board of Directors can make decisions on a limited number of issues established by the Federal Law "On Joint Stock Companies" and the company charter, without trespassing upon the authority of the annual shareholder meeting or executive bodies.

At the same time the issues falling under the jurisdiction of the Board of Directors cannot be delegated to the executive body (sole or collective).

Although the Board of Directors is an elected body with a limited term of office (elected/reelected every year), it is a powerful instrument of influence on the activities of a public company.

The company charter can expand the authorities of the Board of Directors stipulated in the Federal Law «On Joint Stock Companies».

For instance, many public companies granted to the Board of Directors the right to increase the charter capital by an additional issue of shares secured with the company property or by a public offering of common stock accounting for not more than 25% of outstanding shares. This right enables the Board of Directors to raise additional funds for corporate growth and provides protection against hostile merger.

The Board of Directors can be granted the right to establish or dissolve/discharge the company's executive body, either sole (General Director) or collective (Management Board, Directorate).

When the general shareholder meeting, the charter can provide for the right of the Board of Directors to suspend the authority of the sole executive body and establish a temporary sole executive body establishes executive bodies.

The general shareholder meeting only on suggestion of the Board of Directors can make decisions on some corporate issues. Such issues are:

- reorganization of the company;
- increase of the charter capital;
- split or consolidation of shares;
- approval of non-arm's length or major transactions;
- repurchase of own stock;
- joining a holding company, financial industrial group or other groups of commercial organizations;
- approval of internal documents regulating the activities of corporate bodies (general shareholder meeting, Board of Directors, audit board, etc.).

First and foremost the Board of Directors is focused on the issues related to corporate governance. The Board of Directors convenes annual and extraordinary meetings of shareholders, adopts the agenda of the general meeting (including the right to add issues to the agenda and candidates to the list of candidates for the posts in the company management and control bodies).

Although in the new version of the Federal Law "On Joint Stock Companies" the authorities of the Board of Directors have been somewhat limited, the role of this body in the company management and decision making is still very important.

Therefore, it is quite clear why the scope of authority and composition of the Board of Directors are the source of dispute and even struggle between various groups of shareholders.

It is hard to decide whether it would be better to limit or maximize the authority of the Board of Directors. Increasing the list of issues to be decided by the general shareholders meeting seems to be a democratic measure. But this increases the period of decision-making, as the general shareholder meeting should be convened. In a company with a large number of shareholders it also leads to significant expenses. Therefore, most of the public companies choose to maximize the managerial powers of the Board of Directors.

To protect the shareholders' interests the boards should include independent directors, i.e. persons who are not members of corporate executive bodies, do not depend on the company's executive officers, their affiliated parties, or major counteragents of the company and do not have other relations with the company which can affect the independence of judgment. Independent directors on the Board ensure objective opinion on the discussed issues, which in the final count will strengthen the investor' trust in the company.

There are several legal restrictions on the Board's composition. For example, members of the collective management body cannot account for more than one fourth of the Board.

The Code of Corporate Conduct adopted in April 2002 recommends election of independent directors on the Boards of Directors. Currently there are no legal regulations obliging all Russian public companies to meet these requirements and envisaging sanctions for non-compliance or inadequate compliance with the Code's recommendations. At the same time, starting from February 1, 2003, the public companies whose shares are included in the first level quotation lists A of Russian stock exchanges must meet the Code's requirements.

Effective performance of corporate governance bodies largely depends on the qualifications of their members. The law states that the general shareholders meeting may decide to pay compensation to the directors on the Board during their term. We believe it would be correct to make this legal norm obligatory. Compensation paid to the directors on the Board, allows a company to invite highly qualified professionals possessing the required knowledge and expertise.

STEWART FRANCIS NAUNTON

Stewart Francis Naunton, independent director of JSC Kalibr, IDA member, was killed in a car accident July 13th, 2003. Stewart Naunton was a Partner of: PricewaterhouseCoopers (Coopers & Lybrand) in 1984-2002, Co-Chairman of the Capital Markets Committee of the American Chamber of Commerce and Industry (Russia) in 1998 – 2001, member of the Institute of Directors, UK. Stewart Naunton was one of the first members of IDA and contributed much to its development as a member of the Membership and Ethics Committee. We will remember him as a high-class professional, open-minded and buoyant, full of energy and strength.

UK New Corporate Governance Standards Approved*

The Financial Reporting Council, an independent body that oversees changes to the code, approved the revised code, which aims to deliver the biggest shake-up of boardroom culture in more than a decade, July 23d, 2003.

Digby Jones, Director General of the CBI, said that shareholders should now follow the lead of business in adopting higher standards of corporate governance.

"We now want to see institutional investors practicing what they have been preaching with greater transparency in their decision-making and remuneration," he said.

The code was revamped to take into account boardroom reforms proposed by a review of non-executive directors led by Derek Higgs, a former investment banker. After an uproar of criticism from business, much of the language of the original reforms has been redrafted in the new code.

The final draft has gained strong support after months of debate.

Business and shareholder groups declared the FRC had performed the diplomatic balancing act of making the language of the original Higgs review proposals more flexible without watering them down.

Mr. Higgs said that, in spite of the hue and cry over the reforms, the new code incorporated virtually all the 50 recommendations of his review.

"The new code will encourage professionalism and objectivity in the boardroom. Shareholders will benefit from greater transparency and understanding of how boards work," he said.

"The code will raise boardroom standards, drive company performance and help restore confidence in the listed company sector."

Business groups had feared the way the original reforms were drafted was too rules-based and would undermine the role of the chairman and lead to increased board division.

They had been worried that shareholders might adopt an inflexible "box-ticking" approach to assessing whether companies met the increased requirements of the code.

But Mr. Jones said the revised code was a "victory for common sense" that should strengthen boards and bolster the reputation of business.

"The FRC has delivered a code that will encourage better corporate governance but not have damaging unintended consequences," he said.

The new draft is much less prescriptive, with many of the more detailed or broader recommendations reclassified in the Combined Code from provisions to principles or a new category of supporting principles.

Crucially, companies will have to provide only a narrative explanation of compliance with both the principles, which deal with the main issues of corporate governance and the supporting principles, which provide explanatory detail on how to meet them.

This is thought to provide more flexibility for business in complying with the reforms than the more prescriptive provisions. The number of these provisions in the revised code is expected to remain at about the pre-Higgs level.

The main reforms are expected to remain provisions. These include the requirement that half a board should comprise of independent directors and that senior independent directors on a board should attend "sufficient" meetings with shareholders to gain an understanding of their concerns. However, the language has been tempered to stress companies can choose to explain with provisions rather than comply with them if appropriate.

To assuage the concerns of business, the provisions relating to the senior independent director (Sid) will also highlight the role of the chairman in any meetings with shareholders. Companies had worried that the role of the chairman would be undermined if the Sid were required to hold separate regular meetings with investors.

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* *Based on Tony Tassel Investors urged to adopt Higgs standards - 24/07/03, Financial Times (London); July 24, 2003, Thursday London Edition 3; Tony Tassel Higgs: a milestone or a millstone? - 07/07/03 Financial Times (London); July 7, 2003, Monday Surveys GOV1*

Revised Code drops a recommendation that the chairman of a company should not also chair its board nominations committee. Companies had expressed concern that that would jeopardize the chairman's ability to "pick their team", and even Mr. Higgs admitted it was a marginal reform. There are also expected to be concessions to smaller companies, allowing them greater leeway in meeting the code provisions.

One area that is still subject to late wrangling is the recommendation that chief executives should not normally go on to become chairmen of their companies. It has been understood that business has been lobbying to make the language of this recommendation more flexible. In addition, as a concession to business, the new code is expected to clarify that it would not apply retrospectively to incumbent chairmen.

Peter Montagnon, head of investment affairs at the Association of British Insurers, says that changes were needed to ensure that the "comply or explain" approach that has underpinned UK corporate governance standards would not be undermined.

Mr. Montagnon also believes that there "has been a real danger, in the course of this debate, of a serious gulf developing between companies and shareholders". He adds: "If that gulf developed, it would cause grave damage not only to companies but also to the broader economy. It is very important that companies and shareholders now take this process forward in a constructive way."

Anita Skipper, Head of Corporate Governance at Morley Fund Management, says that business should embrace the Higgs Report. "They cannot go back now. The Higgs recommendations are now the standards we seek in companies. Business has to accept things have changed," she says.

NYSE after Sarbanes-Oxley Act

The NYSE Board of Directors has approved new standards and changes in the corporate governance practices of NYSE-listed companies as recommended by the NYSE corporate Accountability and Listing Standards Committee.

The recommendations were initially submitted to the SEC on August 16, 2002 and were amended on April 4, 2003. They are currently under SEC review.

Abstract from Recommendations to the NYSE Board of Directors

1. Require listed companies to have a majority of independent directors.

Effective boards of directors exercise independent judgment in carrying out their responsibilities. We believe requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.1

We recognize that companies that do not already have majority-independent boards will need time to recruit qualified independent directors. We believe that two years should be ample. Accordingly, we recommend that all currently listed companies be required to achieve majority-independence within 24 months of this rule's enactment. Companies newly listing must comply within 24 months. Additionally, given the importance of majority-independent boards, a company must publicly disclose when it becomes compliant with this requirement.

2. Tighten the NYSE definition of "independent director."

   - No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an

* *Действующие правила Нью-Йоркской биржи требуют включения трех независимых директоров.*

organization that has a relationship with the company). Companies must disclose these determinations.

- In addition:

— No director who is a former employee of the listed company can be "independent" until five years after the employment has ended.
— No director who is, or in the past five years has been, affiliated with or employed by an (present or former) auditor of the company (or of an affiliate) can be "independent" until five years after the end of either the affiliation or the auditing relationship.
— No director can be "independent" if he or she is,
or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that employs
the director.
— Director with immediate family members in the foregoing categories must likewise be subject to the five-year "cooling-off" provisions for purposes of determining "independence."

It best that boards making "independence" determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the company, the board should consider the issue not merely from the standpoint of the director, but also from that persons or organizations with which the director has an affiliation.

We believe present employees of a company, or of the company's present auditor, have a material relationship with the company and cannot be deemed "independent." Former employment with the company itself, former employment with the company's present auditor, or present employment with its former auditor, in our view should not be per se bars to an "independence" finding after the passage of a five-year "cooling-off" period. We view compensation committee interlocks as warranting the same treatment. We do not view ownership, or affiliation with the owner, of a less than controlling amount of stock as a per se bar to an independence finding.

3. Empower non-management directors to serve as a more effective check on management.

- The non-management directors of each company must meet at regularly scheduled executive sessions without management.

- The independent directors must designate, and publicly disclose the name of, the director who will preside at the executive sessions.

4. Require listed companies to have a nominating/corporate governance committee composed entirely of independent directors.

5. Require listed companies to have a compensation committee composed entirely of independent directors.

6. Add to the "independence" requirement the following new requirements for audit committee membership at listed companies:

- Director's fees are the only compensation an audit committee member may receive from the company.

- A director who meets the definition of "independence" mandated for all audit committee members, but who also holds 20% or more of the company's stock (or who is a general partner, controlling shareholder or officer of any such holder) cannot chair, or be a voting member of, the audit committee.

- The audit committee chair must have accounting or related financial management expertise.

7. Increase the authority and responsibilities of the audit committee, including granting it the sole authority to hire and fire independent auditors, and to approve and significant non-audit relationship with the independent auditors.

8. Increase shareholder control over equity-compensation plans.

- Shareholders must be given the opportunity to vote on all equity-compensation plans.

- A broker may not vote a customer's shares on any equity-compensation plan unless the broker has received that customer's instructions to do so.

9. Require listed companies to adopt and disclose their corporate governance guidelines.

The following subjects should be addressed in the corporate governance guidelines:

- Director qualification standards.
- Director responsibilities
- Director access to management and, as necessary and appropriate, independent advisors.
- Director compensation.
- Director orientation and continuing education.
- Management succession.
- Annual performance evaluation of the board.

10. Require listed companies to adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors of executive officers.

11. Require listed foreign private issuers to disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

Both SEC rules and NYSE policies have long recognized that foreign private issuers differ from domestic companies in the regulatory and disclosure regimes and customs they follow, and that it is appropriate to accommodate those differences. For this reason, the NYSE has permitted listed non-U.S. companies to follow home-country practices with respect to a number of corporate governance matters, such as the audit committee requirement and the NYSE shareholder approval and voting rights rules. While the NYSE should continue to respect different approaches, listed foreign private issuers must make their U.S. investors aware of the significant ways in which their home-country practices differ from those followed by domestic companies under NYSE listing standards. We also suggest that the NYSE work with its counterparts throughout the world to strive for harmony in corporate governance principles, with the goal of establishing global principles to be implemented by global companies no matter where those companies are based.

12. Require each listed company CEO to certify to the NYSE each year:

- That the company has established procedures for verifying the accuracy and completeness of the information provided to investors; that those procedures have been carried out; and that, based upon the CEO's assessment of the adequacy of those procedures and of the diligence of those carrying them out, the CEO has no reasonable cause to believe that the information provided to investors is not accurate and compete in all material respects. The CEO must further certify that he or she has reviewed with the board those procedures and the company's compliance with them.
- That he or she is not aware of any violation by the company of NYSE listing standards.

13. Enable the NYSE to issue a public reprimand letter to any listed company that violates an NYSE listing standard.

Suspending trading in or de-listing a company can be harmful to the very shareholders that the NYSE listing standards seek to protect; the NYSE must therefore use these measures sparingly and judiciously. We believe that the NYSE should have the ability to apply a lesser sanction to deter companies from violating its corporate governance (or other) listing standards.

The NYSE should be able to issue a public reprimand letter to a company that it determines has violated an NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE listing standards, suspension and de-listing remain the ultimate penalties.

Dividend Policy as an Indicator of Corporate Governance Quality

E.V. Neigebauer, Deputy General Director, JSC "Prospect Investment Company", IDA member

Low dividends are one of the most acute problems of minority shareholders of Russian companies. Alongside asset stripping, transfer pricing and dilution of the equity capital, low dividend payments are included into the list of major problems of Russian corporate governance practice.

- *Low dividends are also one of the reasons of underpricing of Russian stock assets in comparison with Western analogues as stock market participants are reluctant to invest into shares of those companies which do not wish to share profits with minority shareholders.*
- *Market quotations of the companies, which demonstrated their commitment to market corporate governance standards and started to pay adequate dividends to their shareholders, give certain impetus to other companies to re-consider their attitude to the stock market and their own dividend policy. Recent years were marked by the beginning of the new tendency in relations between company management and shareholders. It has become prestigious among Russian companies to adopt corporate governance codes and state their commitment to new dividend policy standards within the framework.*
- *Significantly improved operational results of the corporate sector together with the continuing underpricing (underestimation?) of the majority of Russian shares give grounds to hope that this year shareholders will be able to rely on much more tangible dividend yield. This provides fair opportunities for portfolio investors to receive dividend profit.*
- *Preferred shares traditionally bring their holders the highest dividend yield. In the majority of cases corporate charters prescribe allocation of a certain part of the company's net profit to payment of dividends on preferred shares. Expectations of high dividend payments already resulted in the growth of quotations of many companies.*

Russian joint-stock companies traditionally are hardly to suspect of strong desire to share profit with their shareholders. With a few exceptions the majority of companies pay unacceptably low dividends, which cannot but disturb private investors. Until recently even the shares of the most advanced Russian issuers had been unable to offer portfolio investors dividend yield higher than 4%. Taking into account significantly undervalued Russian stock assets in comparison with Western analogues it is easy to comprehend that domestic companies did not burden themselves with particularly high dividends. Usually companies spent from 7 to 10% of the net profit on dividends, which is significantly lower than similar indicators in Western developed countries where the dividend coefficient may reach 50%.

Dividend yield of blue chips

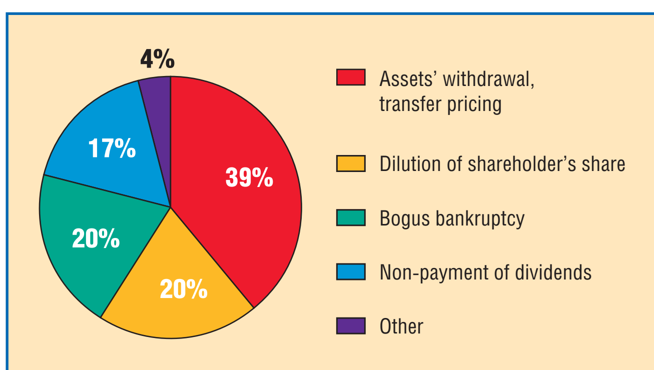
(based on data for 2001-2002)

Shares	Dividend yield
Blue chips	3,24%
Other shares	1,60%

Source: Reuters, estimates of the analytical department of JSC "Prospect Investment Company

Low dividend payments of Russian companies definitely are one of the reasons of their low market value in comparison with Western analogues. While being one of the major quantitative indicators of "usefulness" of shares for a portfolio investor, the dividend size also plays the role of a good corporate governance quality indicator. According to the "Corporate governance in Russia" site, 17% of stock market participants name non-payment of dividends as one of the most typical infringement of rights of shareholders in Russian companies.

The most typical infringements of shareholders' rights



Source: Corporate governance in Russia

Preferred shares

Against the background of the recent unfavorable dividend payment picture it is worthwhile to note the situation with the dividends on preferred shares. According to the applicable legislation and charters, a number of joint-stock companies with preferred shares are to direct 10% of net profits to dividends per such shares. In addition, if the company is not paying dividends on preferred shares, their owners shall be granted voting rights at the next annual meeting of shareholders. Evidently the latter factor hardly corresponds to the interests of management.

Despite the fact that the Russian legislation prescribes joint stock companies to allocate to dividend payment a portion (defined in the company's charter) of net profit, it does not provide for precise definition of "net profit". A number of Russian companies are successfully using this ambiguity for reducing the amount of their dividend allocations. Among the companies actively using this imperfection of the Russian legislation Surgutneftegas is the most notable. To determine the amount of its dividends on preferred share, paid out of the net profit according to Russian standards, the oil company deducts capital expenses as well as social and other expenses, it allows to reduce the ultimate amount of dividends by 4-6 times.

In the nearest future the State Duma intends to adopt amendments to the current law on joint-stock companies according with which the company's net book profit, in accordance with the Russian accounting standards, will be treated as the profit to calculate dividends of a joint-stock company. These amendments undoubtedly will represent a positive innovation.

Dividend yield of preferred shares

(based on data for 2001-2002)

Shares	Dividend yield
Preferred	10,34%
Ordinary	1,60%

Source: Reuters, estimates of the analytical department of JSC "Prospect Investment Company"

Practical experience shows that in addition to the type of a share (ordinary / preferred) the dividend yield is to a greater degree determined by the company's industrial characteristics. The table demonstrates that machine-building companies operating in the most capital-intensive industry pay the least dividends to shareholders.

Significant dividend yield on shares of energy companies can be partially explained by the low capital base effect resulting from the low market value of enterprises in this sector. Oil companies managed to ensure tangible dividend payments due to significant profit growth against the background of global oil prices.

Industry	Dividend yield	
	Preferred shares	Ordinary shares
Oil and gas	9,46%	2,71%
Communications	5,49%	1,14%
Power engineering	25,58%	2,81%
Automotive	7,77%	-
Banks	1,72%	0,98%
Chemical	4,96%	2,64%
Food	2,45%	1,15%
Machine-building	1,22%	0,11%
Metallurgy	-	2,88%
Trade	-	2,12%
Transport	2,69%	1,60%

Source: Reuters, estimates of the analytical department of JSC "Prospect Investment Company"

Regression analysis of market quotation trends failed to identify any statistically significant dependence between share price changes at the date of closure of the register and the level of dividend yield which means that the stock market in general does not react to closure by companies of lists of shareholders entitled to receive dividends on shares. Absence of correlation is observed in relation to both preferred and ordinary shares. In addition, analysis of separate industries also failed to identify any such dependence. This fact may be partially explained by the low level of dividends paid as well as by the low liquidity of the overwhelming majority of Russian shares.

For the full text of the article see www.nand.ru

Pension reform: Long-term Money as a Source of Investment?

The round table discussion "Pension reform: long money as a source of investment" was held by IDA with RTS support July 10th, 2003 in Moscow.

The session was attended by directors of the Boards of Russian companies, IDA members, and newsmen of business media.

R.A. Kokorev, expert of the Bureau of Economic Analysis, and P.M. Teplukhin, President of the management company Troika-Dialog, addressed the round table participants.

Bembia Khulkhachiev, Chairman of the RTS Consulting Council, noted that reform of the pension system is a pressing problem. A full-fledged reform presupposes a developed legal framework, well-defined distribution of roles and delegation of authority. Pension reform will influence the entire financial market development.

According to Rostislav Kokorev, up to the end of 2001 the Russian pension system was based on the "pay-as-you-go" principle, i.e. current pension payments were financed by the funds allocated by employers as payroll taxes. The main changes implemented by the pension reform are as follows: include the saving component in the obligatory pension fund scheme and provide private financial agencies with access to the management of pension funds. The saving pension component depends on the pension contribution rate, which differs depending on the worker's age and wages. Therefore, the pension reform is targeted mostly at the people in the 20-35 age brackets.

Pavel Teplukhin said that pension reform is critical both for the government and for the population. People will be able to transfer the management of their pension funds to professional management teams. Thus, they have a chance to increase their pension accruals significantly by the time of retirement: with the average annual market growth by 7,5% pension accrual may grow 2,7 times in 25 years compared to the simple accumulation scheme.

Maria Churaeva, Chairman of the Board of PIO Global noted that management companies should enter this market right now although the first phase of the project will not be profitable.

Anatoly Gavrilenko, Chairman of the Stock Market Committee of the Moscow Chamber of Commerce and Industry called the audience to initiate a public education program for pension reform promotion among the general public who have still a very vague idea of its contents and goals.

The current stage of the pension reform features a lack of the readiness on the part of the main participants – the government, business and general public. Development of the pension reform will necessitate the solution of quite a few institutional problems: ownership of pension funds, distribution of risks in the pension system, and possible guarantees. A critical success factor will be an adequate information environment.

On September 15th, 2003 the 17th session of the Foreign Investment Advisory Committee was held in Moscow

The session was opened by a stimulating address from Premier M.M. Kasianov, FIAC Chairman. The agenda covered issues regarding improvement of Russia's investment image, development of effective policy in taxation and lifting of administrative barriers impeding the influx of foreign investments in Russia.

Reporting at a meeting of the corporate governance working group organized by Ernst & Young jointly with FCSM were: Alexei Sharonov, FCSM member; Mark Jarvis, managing partner, Corporate Finance; Alexander Ikonnikov, Executive Director of the Investor Protection Association; Kirill Ratnikov, lawyer from Kudert Brothers; Alexander Filatov, Independent Directors Association Executive Director; Yury Gusev, Deputy Director of the Russian Institute of Directors; Rufina Zinatulina, VP, NIKOil, and others.

Taking part in the group's meeting were: I.V. Kostikov, FCSM Chairman; G.I. Kolesnikov, FCSM Deputy Chairman; A.E. Bugrov, Deputy General Director, Interros; A.Yu. Zhdanov, Deputy General Director, Norilski Nickel; representatives from Clifford Chance, Kudert Brothers, Coca Cola, Deutsche Bank, EBRD, Ernst & Young, PepsiCo, Mitsubishi Corporation.

As a result of discussions the group members have arrived at the following conclusions:

The Russian government has made impressive progress in the improvement of the investment climate in Russia. Changes in legislation in 2002 and 2003 and the government's efforts to implement corporate governance best practices have decisively changed the world business attitude towards Russia, which was amply proved by a number of major investment projects implemented in 2003. The working group noted that some of its recommendations formulated in 2002 have been fulfilled while others are being carried out at present.

Members of the working group support endeavors of the Russian government and express their hopes that these will continue. Creation of a favorable investment climate presupposes further improvement of the legislation, its enforcement and appropriate training.

Foreign Investment Advisory Committee Meeting

Incentives to develop capital markets as a basis for heightening the role of corporate governance will ultimately add to the image of Russian businesses in the eyes of both Russian and foreign investors.

Members of the working group were unanimous as to necessity of the further development of mechanisms ensuring appropriate corporate conduct. Special attention was given to issues of the improvement of stock exchanges transparency and governance, further heightening of the role of stock exchanges in the improvement of corporate governance, including through the placement with them responsibilities to suspend transactions of businesses known to have abused the rights of investors. The members also stressed the necessity of teaching Russian entrepreneurs corporate governance principles, and the necessity of developing director professional standards, including the Independent Directors Code.

Resolution adopted by the meeting of the Russian Corporate Governance Improvement Group, Foreign Investment Advisory Council

The meeting of the group discussed the following key issues submitted by foreign members:

1. Developing capital markets as a basis for enhancing the role of corporate governance

2. Training Russian businessmen in corporate governance principles and benefits

3. Imposing sanctions for corporate governance irregularities

4. Enhancing the performance of Boards of Directors

5. Audit committees as a corporate governance tool

6. Internal audit as a corporate governance tool

7. Reducing tax burden on management compensation schemes

8. Enhancing the role of stock exchanges in securing corporate governance and shareholder rights

9. Improving corporate transparency

As a result of the discussion, the group made the following conclusions:

The Russian Government has achieved major success in improving the domestic investment climate. Legislative changes effected during 2002-2003 and the Government's focus on implementing corporate governance principles caused positive changes in attitudes to the Russian economy and, more specifically, helped implement major investment projects involving foreign investors in 2002. It is worth noting that certain recommendations, issued by the group in 2002, have been fulfilled, and work on certain others is now underway.

The group supports the Government's efforts and hopes that they will be continued. Creating a favorable investment climate calls for future steps to be taken in order to improve legislation, law enforcement and training. Steps designed to develop capital markets as a basis for increasing the importance of corporate governance will ultimately help improve the investment image of Russian entities both domestically and internationally.

In view of the above, the group recommends the following:

Improving the regulatory framework

It is necessary to further implement recommendations which were already issued by the group, including:

— Undertaking steps designed to improve laws which govern the restructuring of commercial entities and acquisitions paving the way for a wide range of business restructuring transactions, together with promoting effective safeguards for investors involved in restructured entities and for commercial entities which are acquired;

— Adopting the Insider information Law that would protect investor rights in terms of access to information on the securities market.

Also, the following law improvement efforts must be undertaken:

— Adopting the Law on Affiliates that would help disclose information on related parties and rely thereon to monitor transactions which are performed by companies;

President of European Bank of Reconstruction and Development Jean Lemierre, Prime-minister Kasyanov, and CEO of Ernst & Young Global James Turley at the press conference held after the plenary session of the FIAC.

— Adopting amendments to the Securities Market Law that would provide a clear-cut definition of rights to securities.

Improving law enforcement

— Adopting amendments to criminal and administrative laws with a view to establishing liability for violations of shareholder rights;

— Strengthening the law enforcement powers of the Federal Securities Commission of Russia;

— Making it possible for the FSMC and law enforcement authorities to apply effective law enforcement procedures for protecting investor rights.

Developing proper corporate governance tools

— Improving the efficiency of Boards of Directors through strengthening their members' liability for decisions adopted, engaging independent directors in the work of BoDs, paving the way for insuring the liability of directors, improving their professional skills, and disclosing information on their financial interests;

— Promoting the work of audit and compensation committees;

— Drafting a document with recommendations on the performance of independent director functions (the Code of Independent Directors).

Improving the transparency and corporate governance practices at stock exchanges and further increasing the role of stock exchanges in securing proper corporate governance, including by means of obliging them to suspend operations if investor rights are violated

Further improvement of corporate transparency

It is necessary to further follow the announced IFRS transition plans and undertake steps designed to promote the independence and responsibility of external auditors.

Training Russian businessmen in corporate governance principles and benefits

Better Corporate Boards Practices: Increasing the Role and Contribution of Independent Directors

Under the U.S. Agency for International Development (USAID) award, effective for the period through December 2005, IDA is implementing a program for which includes two activities modules:

1. Practical workshops and round-table discussions.

Series of practical workshops and round-table discussions will be organized in order to facilitate upgrading of professional qualification of independent directors and to improve boards efficiency by promoting best independent directors practices. Target groups: Russian corporate directors, members of executive boards, dominating shareholders (owners), representatives of minority shareholders, investment funds, portfolio investors, independent directors to the Russian companies.

2. Survey and Conference "Balancing the boardroom: recognizing board diversity and significance of women on the board".

Targeting under-representation of women on the Russian Boards of Directors, Association will conduct research resulting in publishing and disseminating Survey on current situation with women representation on the Boards of Directors of Russian JSCs and holding an international conference "Balancing the boardroom: recognizing board diversity and significance of women on the Board". The aim is to poll the opinion of the Russian business community regarding the role of women on the Boards, to analyze current situation with women representatives on the BoD of Russian JSCs and increase public and professional community awareness of this issue in order to increase the number of women – independent directors nominated and elected to the Boards of Russian JSCs.

Development of guiding principles and implementation of Codes of business conduct and ethics for directors

In 2003-2004 IDA and Russian Institute of Directors (RID) will continue to implement the joint project of finalizing, promoting and disseminating Codes of business conduct and ethics for independent and corporate directors. The project goal is to develop guiding principals for directors, officers, and employees, based on experience in developing Independent Director Code and Professional Directors Code. The program is funded and supported by the Department of Commerce of the U.S. International Trade Administration.

Main Objectives of the Project:

— To develop and to promote wide discussion and dissemination of the codes of business conduct and ethics for independent and corporate directors and guiding principals for directors, officers, and employees.

— To advocate for the positive role of the investors' representatives and independent non-executive directors on the Boards.

— To provide an opportunity for corporate managers and owners to get an advice on the professional directors ethical behavior on the Boards of the Russian Companies.

— To provide information for the Russian and international business community on the state and trends in corporate governance in the Russian corporations by disclosing corporate governance procedures and demonstrating best investors' representatives practices on the Board of Directors.

The developed Codes and guidelines will be presented to the Russian stock exchanges, Chamber of Commerce, the Russian Union of Industrialists and Entrepreneurs, the Business Russia and the National Council for Corporate Governance.

In case you are interested to participate in these projects please contact us at tel.: (095) 938-6651 or by e-mail: info@nand.ru

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