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### CORPORATE GOVERNANCE: RULES FOR A CIVILISED GAME IN THE INVESTMENT MARKET



7-8 December 2004. The Federal Investment Forum was held in Moscow; it was the final event of the year on the Russian finance market.

The section "Corporate Governance: Rules for a Civilized Game in an Investment Market" was organized within this forum by the Independent Directors Association (IDA), the International Finance Corporation (IFC), and the magazine Upravlenie Kompaniey (Company Management) (publishing house "RCB").



The following people spoke during the section: Konstantin Fradkin, deputy head of the Property Management Department for Commercial Sector Organizations of the Federal Agency for Federal Property Management; Andrei Bushev, director of IDA's North-West regional branch; Ekaterina Makeyeva, corporate governance advisor, TNK-BP Management LLC; Svyatoslav Masyutin, chairman of the board, Safonovo Machinery Plant; Oleg Shvyrvkov, senior analyst from Standard & Poor's.



The following people participated in the discussion: Sebastian Molineus, project manager, IFC Russia Corporate Governance Project; Patrick Luternauer, IFC Russia Banking Sector Corporate

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Governance Project; Oleg Fyodorov, corporate finance director, UFG; Alexander Filatov, IDA executive director, and others.

During the discussion the focus was on the analysis of the most urgent issues of corporate governance (CG) in Russia.

Two speeches in the section were dedicated to CG problems which are directly related to the processes of mergers and acquisitions.

In the beginning of his presentation K. Fradkin proposed his own version of the ideal scheme for the behavior of a company when preparing for a merger or a takeover. This scheme includes the following components: planning; assessment of legal and actual risks; and risk minimization methods.

In Fradkin's opinion of , the risks have recently increased in the sphere of mergers and takeovers for companies in which the state holds a significant share.

These companies need effective protection against hostile takeovers. One of the methods of protection is for the state to delegate representatives (authorized persons) to the board and key committees. Due to various reasons, however, the effectiveness of the work of these authorized persons is rather low, as the importance of their work and of the goals they have is often undervalued by other officials representing private investors and shareholders. As an alternative, the procedure can be used where the state delegates not just representatives to the board, but highly qualified professionals and directors. But even in these cases the problem of the delegated persons being interested in protecting the state's interests when deciding on the most important issues of strategy and business development is not solved entirely.

This is why, as Mr. Fradkin believes, from the point of view of protecting the state's interests, it would be more appropriate for the state to ensure these companies have legal entities — and not individual persons — representing the state. Problems of affiliated persons or conflicts of interests could be minimized when the company uses an audit firm that provides services to several corporate clients as a “collective inspector”. In this case, if the firm's employees make serious errors or commit serious violations of business ethics, the firm would bear the responsibility for their actions.

In respect of state representatives' board membership, it would be appropriate to appoint these representatives from the membership of professional associations or unions (e.g., IDA). These organizations would then serve as guarantors for the high professionalism and conscientiousness of directors they recommended.

## NEWS BRIEFS

**17 December**, Hotel National, Moscow; New Year's Eve party for the members and partners of the Independent Directors Association (IDA).

**7-8 December**, Moscow, Federal Investment Forum; The IDA, the International Finance Corporation (IFC) and the magazine Upravlenie Kompaniey (Company Management) organized a section “Corporate Governance: Rules for a Civilized Game in an Investment Market”. (See p. 1– 5)

**7 December**, the regular meeting of the IDA Committee on Membership and Ethics was held, eight

new members were enrolled into the Association. (Brief data on the new IDA members can be found on p. 19).

**3 December**, release of “The Russia Corporate Governance Manual”. This publication is the result of two years of work by specialists from IFC's Corporate Governance in Russia project. This guide contains detailed descriptions of practices for building a corporate governance system in Russian companies that functions in accordance with international standards.

**25 November**, the winner of the Russian segment of Ernst & Young's International (conducted in 40 countries of the world) Entrepreneur of the Year competition was announced. The president of the Troika Dialog

Mr. Fradkin announced that currently the Federal Agency for Federal Property Management is putting together proposals on professional associations' participation in the CG system of companies with a large state share in their share capital.

The problem of mergers and takeovers was the main theme of A. Bushev's presentation, "How Well Does a Director Manage His Duties During a Merger or a Takeover?" In the regulation of this issue Russian legislation follows foreign legislative acts in many respects. When summarizing foreign legal practice in the assessment of the director's work (or that of the chairman or a member of the board of directors), two main approaches can be seen:

1. Assessment from the point of view of him having a duty to act in the interests of the company;
2. Assessment from the point of view of business judgment rules.

The latter needs some further explanation. In essence the rules and principles of CG give the answer to the question as to what degree the actions of a director during a merger or a takeover conform to the rules of the business judgment. Naturally, a director cannot be held responsible if he: a) had full information on the future merger or takeover and b) if he reasonably believed that he acted in the interests of the company as a whole.

Mr. Bushev pointed out that in the Russian legislation there is a norm which defines fiduciary duties of a director; it stipulates that not only should he carry out his duties conscientiously and reasonably, but also

actively protect the company's interests. A director's inaction or action in his own interest is considered an offence.

It is clear that a merger or a company takeover cannot leave its director indifferent, as changes in the business organization also mean changes in the director's status. There is always a director's personal interest as regards the conditions of the merger or takeover; what is important is that personal interest should not contradict the interests of the company as a whole.

In his presentation Mr. Bushev gave several examples of such behavior by foreign corporation directors (*Mannesmann v. Vodafone*; *Smith v. Van Gorkum*).

What practical steps should the board chairman and company directors take in order to minimize the threat of a hostile takeover? The list suggested by the speaker includes the following points:

- Define what exactly is most attractive in the company for the "invaders";
- Assess the probability of the takeover;
- Design and implement measures for the protection of the company against a hostile merger / takeover;
- Regularly consider merger / takeover-related issues on board meetings;
- If the threat of a takeover becomes real, the board chairman should put all other issues aside and concentrate fully on the solution of problems related to

group of companies, Ruben Vardanyan, won. He will represent Russia at the finals in Monaco in June 2005.

**16 November**, Moscow, the international conference "Balancing The Boardroom: The Role of Women in Company Management" was held; it was attended by about 100 representatives of business, community organizations and professional associations of directors. IDA, USA-Russia Business Forum, and the Center for Business Ethics and Corporate Governance (St. Petersburg) organized the event within the USAID-funded Russia Corporate Governance Program. Results of IDA's 2004 study on the subject matter were presented at the conference. (Further information on p. 5 – 9)

**10 November**, a round table on issues of corporate governance with Robert Strahota, Assistant Director, US Securities and Exchange Commission's Office of International Affairs, was held in Moscow. IDA, USA-Russia Business Forum, and the Center for Business Ethics and Corporate Governance (St. Petersburg) organized the event. (Further information on p. 10 – 13)

**25 October**, IDA and IFC signed an agreement for a joint, long-term program on corporate governance in Russia. The agreement calls for a joint team of experts to be built in order to provide Russian companies advisory services covering a broad spectrum of issues involved in the implementation and development of principles of corporate governance based on advanced experience and international standards.

the takeover. In no circumstances should the board's chairman or members make decisions on arising problems single handed. A qualified specialist in mergers and takeovers should be employed by the company;

- During the process of a merger or takeover, the board chairman should be in full control of the situation, must remain the “head of the process”, should find time and financial resources to prevent threats to the company's interests.

E. Makeyeva presented the work being done on the introduction of changes to Russian legislation in the CG sphere. This work is being carried out in three areas: Firstly, the experts consider it necessary to change the existing typology of legal entities, of which the deciding criterion of differentiation is currently the form of ownership. From the point of view of economics some types of legal entities, for instance OJSCs and CJSCs, are hard to differentiate, because in both cases we see a union of a group of persons and capital. There are many disputable issues in the current procedure for the registration of legal entities organized as unit funds. Secondly, in the CG sphere there is a need for clear interpretation of the notion “group of persons”, which currently is only applicable in the context of antimonopoly legislation. Nevertheless this term is used in the practice of consideration and resolution of conflicts arising within relationships between the parent and subsidiary companies, of redistribution of authorities, when protecting interests of creditors and shareholders, and in other disputes. Thirdly, changes in the current legislation should reflect the important issue of managing conflicts of interest. This is why it is important to introduce the notion of an affiliated person into the CG legislation.

On the whole Ms. Makeyeva thinks changes in Russian CG legislation should correspond to the principle of cost efficiency.

In his presentation S. Masyutin analyzed the specifics of CG in the Russian regions. As the speaker admitted, over the past several years he has been reflecting on the question of whether corporate governance in Russia is merely a toy for a chosen few large corporations or an efficacious tool for the development of business for the hundreds of thousands of joint stock companies in Russia.

The answer to this question could be provided by market research studies conducted recently by

leading Russian consultancy companies and business publications. Mr. Masyutin talked in detail about the results of one such study, the CG rating of Expert magazine. The overwhelming majority of the 116 companies included in the study are based in Moscow and St. Petersburg. It is Moscow, too, where the majority of seminars on CG issues are conducted — in 2003-2004, 94 out of 151 practical training events of this nature were held in Moscow.

It cannot be said that companies working in the regions ignore CG issues entirely. However, there is a whole range of factors which hold back the development of CG outside the capital cities. These factors include:

- Reluctance of the owner to hand over company management to employed managers and independent directors. This peculiarity of business organization is much more pronounced in the regions than in Moscow and St. Petersburg;
- Imperfection of the legislation;
- Inadequate understanding by proprietors and managers of the essence of CG and its advantages for business development. As surveys conducted in various regions of Russia show, only one or two managers from several hundred surveyed were capable of giving a correct answer to the question of what CG is;
- The lack of understanding amongst local administrations of the necessity to develop CG in companies, which hinders local companies and authorities' representatives from speaking the same language. As Russian practice shows, only in those regions where there are CG specialists within the authorities' structures can one expect constructive dialogue. The Smolensk region can serve as an example of such a region; a TESIS project on CG is running there and there is a specialist in the administration responsible for liaising with companies on the issue.

One of the elements of the CG system is the relationship between managers/proprietors of the company and independent directors. The attitude of proprietors/managers towards independent directors is just as contradictory as the attitude towards corporate culture and the CG system as a whole. Mr. Masyutin thinks that businessmen with stable reputations and respectable specialists are too few for companies to enroll them as independent directors. This lack of candidates for the post of independent director could be compensated by co-opting the company's top managers to serve on the board of

directors, provided they have sufficient qualifications to carry out board member duties.

Mr. Masyutin told of one interesting initiative at the Safonovo machinery plant. An advisory panel was established at the plant in order to carry out independent expert evaluations of informational materials and documents to be considered by the board at board meetings. The members of the panel are well-known scientists and specialists in various industries and the financial sphere.

The magazine Expert is not the only organization involved in rating Russian companies in the area of corporate governance. A well-known company, Standard & Poor's (S&P), also works in this sphere. As O. Shvyrkov told the audience, interest among Russian companies to CG ratings rose immediately after the financial crisis of 1998, when it became necessary for domestic businesses to be more attractive to foreign investors. Russian companies saw the high CG rating as some sort of PR action, which could help obtain cheaper credit or better terms for repayment of debts.

In response to requests from these companies, S&P designed a method of CG rating applicable to the Russian market. Here, the CG rating is understood to be a combined opinion of analysts on the issue of risk assessment involved with the CG in a particular company.

As further events have shown, CG ratings had played an important role in the business development of several large Russian companies. Although different from traditional credit ratings, as CG ratings belong to the non-financial category, they can be used by investors and creditors when making decisions on share purchases or loan provisions, and thus can affect the market value of a company. S&P CG ratings assess the efficiency of the CG system and the work of the board of directors, as well as risks due to management errors.

Mr. Shvyrkov also spoke about the method used currently by S&P for CG ratings. It was pointed out that only two Russian companies had high CG ratings from S&P. The majority of domestic companies are in the middle level CG category. We also have to take into account that S&P rates those businesses which themselves request a rating. This is why the level of CG system development in these companies is undoubtedly higher than the average across Russia.

## BALANCING THE BOARDROOM OF RUSSIAN COMPANIES



16 November, Moscow, the international conference "Balancing the Boardroom: the Role of Women in Company Management" was held; attended by about 100 representatives of business, community organizations and professional associations of directors. The event was organized within the USAID-funded Russia Corporate Governance Program by Independent Directors Association (IDA), USA-Russia Business Forum, and the Center for Business Ethics and Corporate Governance (St. Petersburg).

During the first part of the conference, presentations were given by Yelena Koneva, director general, COMCON; Debra Nelms, founder and director of Network Search Inc.; Mikhail Samosudov, deputy director general of the Corporate Governance Institute; and Dmitri Cherkayev, director of the IDA Research Center.

During the second part of the conference there was a discussion about the presentations from the first half of the day, and a general discussion on balancing the board of directors. Besides the presenters, the following people took part in the discussion: S. Tsybukov, a board member of OJSC Komsomolskaya Pravda; S. Lakina, head of the Corporate Governance Department OJSC Rossiyskaya Elektronika; O. Miller, department manager in OJSC Rossiyskiye Zheleznnye Dorogi (Russian Railways); R. Zinatulina, vice president of NIKOil and IDA board member; and A. Filatov, IDA executive director.

In a presentation entitled Women – Business Leaders in Russia, E. Koneva composed a portrait of the modern female Russian manager based on the data obtained in market research conducted by COMCON.

Despite the fact that number of women is larger than the number of men in Russia, many more men work in managerial positions. Almost two thirds (64%) of managers in companies and organizations registered in the Russian Federation are men, and just over one third (36%) are women. The gender structure of company proprietors is not in women's favor either — only 31% of business entities have women as proprietors.

The highest proportion of female managers is observed in state owned enterprises — 44%, the lowest — in foreign companies (representative offices) — 27%.

The proportion of women amongst managers on the whole decreases with the increase in size of the company (organization). In companies (organizations) with between 50 and 100 employees, women make up 42% of managerial staff; in companies (organizations) with over 500 employees, the proportion of women among managers decreases to 30%.

Industries and sectors of the Russian national economy still fall into two categories: “male” and “female”. In the sphere of culture and art, health service and education, the proportion of women as managers far exceeds that of men. By contrast, in the military, the Ministry of Internal Affairs, construction and transport industries, the number of men as managers is much higher than of women.

In Koneva's opinion, “male” and “female” styles of leadership can be differentiated in Russia. The male leadership style is more authoritarian, it is more effective in “polarized” situations — when logical plain decisions have to be made and also when, in contrast, issues of a high degree of uncertainty are being decided. As regards the “female” style of leadership, it is more flexible and effective when working on routine problems which demand a longer period for resolution.

Studies show that responsibility and honesty are the most valued business qualities among Russian women; among Russian men a high education level and the ability to demonstrate self-sufficiency/independence in the decision making process and when executing orders are most valued.

Ms Koneva believes the data gathered by COMCON allow us to draw a “portrait” of the contemporary female Russian leader. What makes it different from the portrait of a male leader is this:

- A higher degree of social responsibility due to giving more attention to issues of personnel management;
- The aspiration to observe laws and behavior norms in the business environment;

- Higher responsibility when fulfilling obligations;
- A lesser tendency to rely on state assistance in solving business problems (70% of female leaders think that the state should not interfere in the activities of their companies/organizations).

Ms Koneva reckons that the role of women in company management will grow. The tendency to move away from an authoritarian, “male” management style toward a joint, more flexible “female” style can be observed both in Russia and abroad. As COMCON studies demonstrate, women as leaders in Russian companies manifest a disposition to teamwork.

Problems of the collective approach in the practice of corporate governance were reflected upon in the presentation of M. Samosudov, deputy director general of the Corporate Governance Institute, entitled “Effective Work of Boards of Directors: Russian Practices”.

As the speaker noted, a board of directors is a body of collective governance. The key characteristics of collective bodies of governance are the following:

- They are best adapted to the accommodation of interests of different participants;
- They are most efficient for defining and solving problems of a strategic nature.

However, the overall balance of a board is dependant on the degree the individual qualities, and psychological, personal factors and qualification of its members are taken into account.

The balance of the board of directors is an important factor in the success of the company. This opinion was heard in the presentation of D. Nelms, the founder and director of the American company Network Search Inc.



One of the factors providing for the balance and the effectiveness of a company's board of directors is women participating in its work. According to data from Business Week Magazine (USA), corporations with the highest proportion of women on their boards of directors have on average 35% higher return on equity (ROE) and 34% larger annual total return to shareholders (TRS) than corporations where women are represented in smaller proportion on boards of directors.

The increasingly active participation of women in the process of corporate governance, and the increase in the proportion of women on boards of directors, reflects the growing role of women in the American economy as a whole.

Currently women purchase 83% of all goods and services in the USA; they make up 88% of all retail buyers. Ninety-one % of new homes and 80% of cars in this country are either bought by women themselves or at their request or with their advice.

The role of women in the development of enterprise in the USA has also been growing over the last few years. Almost every tenth adult American woman now owns a business. According to data from the Center for Women's Business Research, 6.2 million businesses controlled by women were registered in the USA in 2003.

The results of the center's studies demonstrate that in 1997-2002 the growth rate in the number of companies controlled by women was highest in such sectors of the American economy as construction (aggregate growth 36%); agriculture services (27%); transport, communications and domestic services (24%); and finance, insurance and real estate (14%).

In contrast to Russian practices, women in the USA are achieving success in the same industries and sectors of the economy as men, that is in the sphere of industrial manufacturing, wholesale trade, retail services and construction.

The proportion of women among the management of large American corporations is also growing. Women currently make up 7.1% of the executive finance directors of Fortune's 500 leading American companies. The proportion of women on the boards of directors of the Top 500 American corporations is even higher — 13.6%. In 2003 there were 557 women holding 779 positions on boards of directors of these companies. Compared to 2001, the number of women on boards of directors of the Top 500 American corporations has grown by 5.7%, or by 30 persons.

The quoted data by Ms Nelms serve as proof of the exceptional importance of the "female component" in the system of corporate governance of large American companies.

The main results of the research into the balance on boards of directors of Russian companies were presented in the talk of D. Cherkayev, director of the IDA Research Center.

Up until now no integrated research was done into the issue of the balance in the structure and activities of a board of directors in Russia. At the same time, as global experience shows, research of this nature encourages both the development of additional corporate governance resources and the work of the board of directors.

Ninety respondents from 80 large- and medium-sized corporations took part in the first Russian research of the balance of boards of directors; these included Norilski Nickel, Sberbank RF, Svyazinvest and its interregional subsidiaries, Alrosa, OMZ, RBK, Severstalavto. Eighty-four % of respondents represented the management of these companies. Fifty-eight % of respondents were female and 42% were male.

Thirty % of the companies are based in Moscow and the Moscow region. In terms of industry the selection consisted predominantly of companies working in telecommunications (17%), services and retail trade (16%), and machinery (14%).

The overwhelming majority of respondents work for companies which are either considered to be leaders in their sphere or are fast-growing businesses.



In Cherkayev's opinion, a universal indicator is useful for analyzing board activities, especially the balance of the board.

Various aspects of being balance were analyzed in the study:

- Board membership;
- Roles and functions of board members;
- Degree of representation of all interested persons.

Within the study of the membership of the board and the roles and functions of its members, respondents were asked to name functions which in their opinion should be assigned to women within a board of directors. Roles and functions of board members were graded in accordance with the method of the well-known British corporate governance specialist, R. Tricker.

### Coordinating roles:

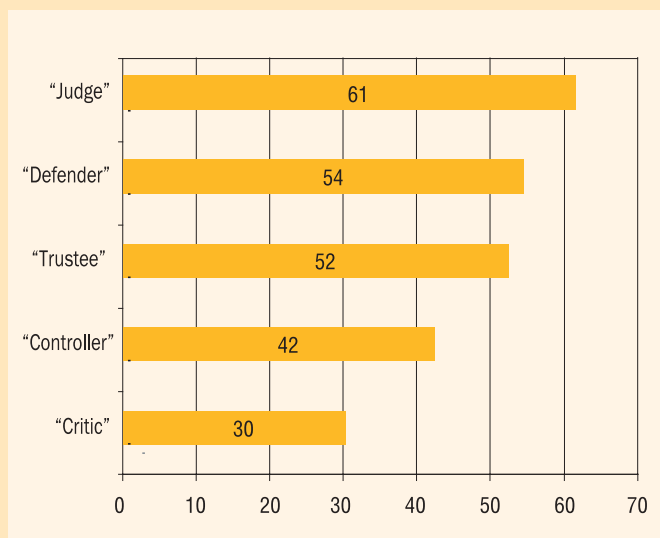
“Judge”	Objective situation assessment, weighing up different opinions
“Critic”	Initiating discussions at board meeting
“Controller”	Control and supervision over management
“Defender”	Protecting shareholders' interests
“Trustee”	Link between the board and other interested parties — shareholders, management, suppliers, etc.

### Functional roles:

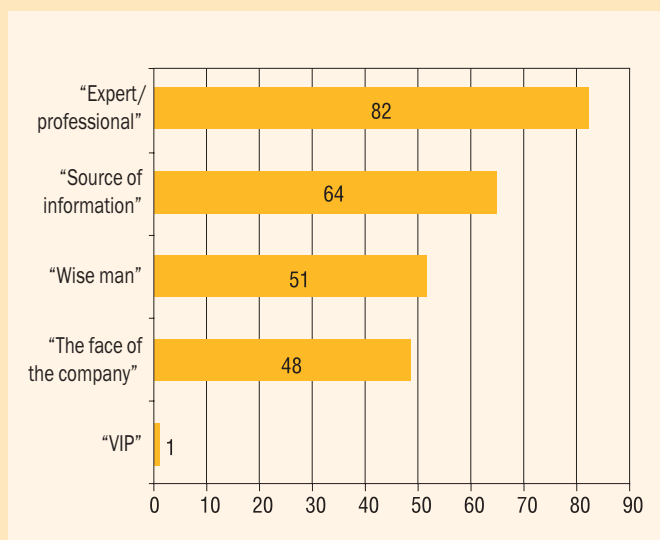
“Wise man”	Wisdom and rich life experience
“Expert / professional”	Highly qualified specialist in certain sphere
“Source of information”	Professional information bearer
“The face of the company”	Representative of the company in dealings with the media, bodies of authority, etc.
“VIP”	Very well-known person, nominally on the board

Respondents were requested to pick the three most important roles out of these. Diagram 1 shows the distribution of answers for every option.

**Diagram 1**  
Coordinating roles of female directors – board members (percent distribution)



**Functional roles of female directors – board members (percent distribution)**

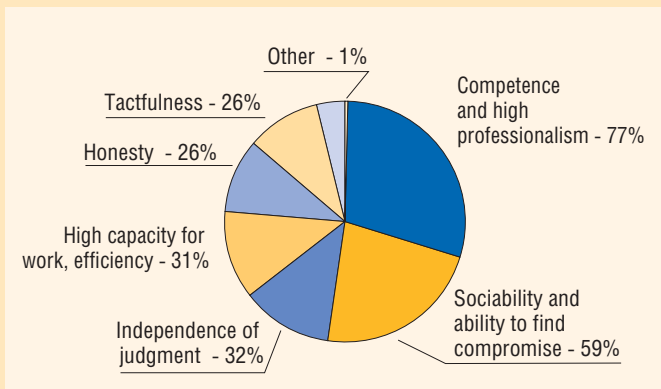


Along with establishing functional and coordinating roles for board members, the participants of the study stated professional qualities which, in their opinion, women holding the position of board member should possess.

Among the suggested options in the questionnaire, respondents were asked to choose the three most significant in their opinion. The results are presented in Diagram 2 (the figures shown reflect the sum total of votes “for”).

**Diagram 2**

**Coordinating roles of female directors – board members**

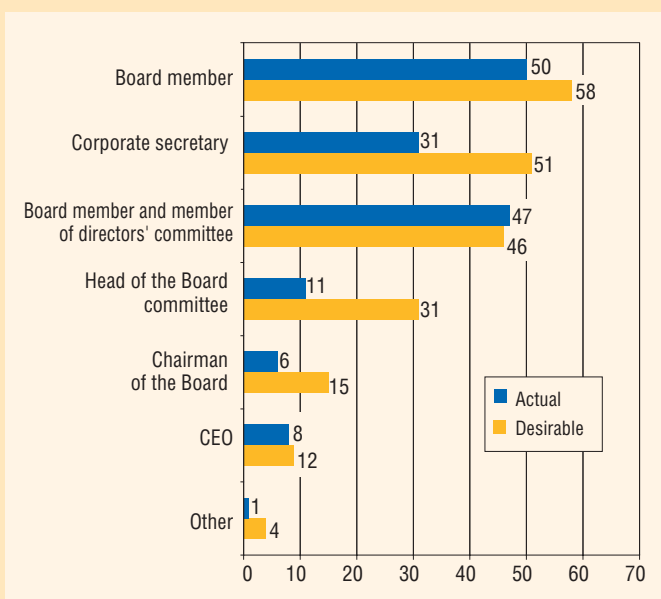


The two most significant professional qualities of women as leaders were found to be “competence and high professionalism” — 77 votes and “sociability and ability to find compromise” — 59 votes.

One of the goals of the study was to learn in respondents' opinion of the optimal (desirable) distribution of women in leadership positions in companies and compare that figure with the actual numbers in companies. The results of the comparison are presented in Diagram 3. The figures reflect respectively the following: a) actual distribution of leadership positions among women in the companies studied; b) respondents' opinion of the optimal distribution of women in leadership positions for the highest possible contribution to the development of the company.

**Diagram 3**

**Actual and desirable distribution among women in leadership positions**



The study results lead to the following conclusions about the role of women as leaders and their contribution to the boardroom balance in Russian companies.

1. The proportion of company boards of directors with women is rather high (56%). The average indicator of female presence on the boards of the companies studied is 12%, while the average board size is between nine and 11 persons. The results of the study confirm the rough correspondence of Russian and foreign indicators of the quantitative participation of women in the work of the board (in 2002, according to the data from the Investor Responsibility Research Center, Washington, women held 13% of the seats on boards of S&P 500 companies).
2. The study revealed that the two most significant professional qualities of female directors were found to be “competence and high professionalism” and “sociability and ability to find compromise”. Amongst the roles and functions of female directors on company boards, the “expert-professional” and “judge” roles prevail. These professional qualities correspond to the optimal roles and functions of women on a company's board as chosen by respondents.
3. The study demonstrates that there are fewer women in leadership positions than what respondents consider optimal (desirable). The biggest gap between the actual and the desirable levels is observed in such key positions as board chairperson (six actual instead of 15 desirable), head of directors committee (11 against 31), corporate secretary (31 against 51).
4. From the study, one can conclude that when looking for female board member candidates, most respondents “stew in their own juice”, limiting themselves by looking only amongst representatives of executive bodies of their own companies (42%) and shareholders (14%). This could possibly be explained by the absence of search mechanisms or information banks, or of fear of disclosure of internal company information.

## ROUND TABLE WITH ROBERT STRAHOTA

**Robert Strahota** began his career in 1964 as a finance analyst in the Division of Corporate Finance of the US Securities and Exchange Commission (SEC). In 1972, he joined the law firm Kirkland & Ellis where he specialized in issues of corporate law. In 1977 he became a partner in the company.

In 1991, Mr. Strahota returned to the SEC as Senior Advisor in the Office of General Counsel. Since September 1993 he is the assistant director of the Office of International Affairs. His main duties and areas of work include: managing SEC programs on technical assistance for entering the US securities market and analyzing and commenting on legislative acts and SEC rules regulating issues of securities trade, corporate governance, and financial accountability.

From In 1992-1993 Mr. Strahota held the position of senior advisor of the Securities Commission of Poland, for which he was awarded Officer's Cross for his services to the Republic of Poland.

Mr. Strahota is the author of numerous articles and analytic materials on various aspects of how the securities market works in the USA and how it is regulated. He lectured in Georgetown University Law Center, Washington, DC, USA; Warsaw University, Poland; and Government Law College, Mumbai, India.



The roundtable on issues of corporate governance was held 10 November 2004 in Moscow in the building of MICEX and organized by the Independent Directors Association (IDA), USA-Russia Business Forum, the National Association of Securities Market Participants (NAUFOR), and the Center for Business Ethics and Corporate Governance. The event was organized for

IDA and NAUFOR members within the USAID-funded Russia Corporate Governance Program.

The main point on the program was a talk by Robert D. Strahota, assistant director, US Securities and Exchange Commission's Office of International Affairs.

In his talk, Mr. Strahota commented on the chapters of Sarbanes-Oxley Act that are applicable to foreign companies listed on the largest security exchanges in the USA. He specifically mentioned the most recent changes in SEC rules with respect to foreign issuers.

Below is the summary of main points of Mr. Strahota's talk.

### 1. Sarbanes-Oxley Overview

Sarbanes-Oxley Act (SOX) was passed in 2002 and is the most important act about securities since 1933, i.e., from the time when SEC was formed. I cannot agree with the point of view that this act was passed by the American Congress in a rush, merely as a reaction to those widely-known, large financial and corporate scandals. These crisis events really served, in a sense, as a catalyst to the passing of the new legislative act on securities. Corporate scandals made all the interested parties get together and draft the new bill. However, many of the SOX provisions had been in development for a long time; suggestions from representatives of various industries and the largest exchanges were taken into account in drafting the bill.

I also think that the whole range of SOX provisions reflects the situation as it stands, not only in the USA but in other countries as well. Many issues reflected in SOX are not particular to the American stock market and practices of corporate governance in the USA; It would be enough to mention the Parmalat or Royal-Dutch Shell scandals. This is why I assert that SOX answers essentially global questions.

SOX applies to both American and foreign issuers and there is generally no distinction between US and foreign issuers seeking access to the US capital markets.

First of all I would like to consider in more detail the two SOX provisions which, in my view, are very important for foreign issuers; these provisions are the audit committee requirements and the system of internal control over the quality of financial reporting.

### 2. SOX Audit Committee Requirements

When passing SOX the US Congress demanded that by 1 April 2003, SEC should draw up rules which would prohibit American exchanges to list companies

that do not comply with the principle of independence of directors in the audit committee, regardless of which country they are from. In public companies this requirement means that: a) the audit committee has to be represented on the board of directors of the company; and b) only independent directors can be members of the audit committee. When applied to companies with the so called single-level corporate governance system, the whole board of directors is viewed as the audit committee.

In SEC's understanding, an audit committee member is considered independent if this member receives no fee from the issuer except in his capacity as a member of the audit committee, another board committee or the board of directors. Neither can an independent director be an affiliate of the issuer or any subsidiary structure. And lastly an independent director cannot have controlling interest in the company. If, for instance, a director holds 10% of all the company's shares — and there is no other shareholder with more shares — then this director will not be considered independent. But if this director has 10% of all company shares, but there is another shareholder with more shares, then this director will not have controlling interest.

After SOX came into force, many letters and appeals came to the SEC from foreign companies listing the peculiarities of corporate governance in these countries which would not allow these companies to fully comply with the requirements of the new act and SEC rules.

For example there were appeals from German companies citing the German legislation in respect of the oversight committee membership, employment dismissal conditions for directors of public corporations, the position of the state as a shareholder, etc. Several times we were visited by representatives of large Japanese corporations; they told us of the specifics of Japanese corporate culture, which is based upon the principle of gradual progression up the career ladder, the denial of significant influence to independent directors (in some Japanese corporations there are no independent directors, and in others the proportion of independent directors on the board does not exceed 30%). This is why, as representatives of Japanese companies explained, it was not possible to form the audit committee purely from independent directors in Japan.

In some countries there is a practice of election or approval process for audit committee membership at a general shareholders meeting. This practice does not exist in the USA and thus initially in

SOX and our rules there were no clarifications on the matter.

What surprised me? We received no comments regarding SOX and the new SEC rules from Russia. I am not sure whether this was due to the fact that the FSCM and other interested organizations and Russian companies simply did not know of our work on the new legislation on securities, or they were happy with it all. At least we received no complaints from Russian companies working on American capital markets, we were never told of them having any problems.

In any case, after discussions with representatives of foreign companies and studying peculiarities of the legislation of countries where they are based, SEC introduced certain changes in the interpretation of SOX audit committee requirements. On April 1, 2003, the SEC adopted the final redaction of rules for the audit committee formation and work. These rules state, for instance, that some provisions will not apply to foreign issuers until 2005. For example, for foreign companies listed or planning to be listed in American exchanges, certain exemptions from the SEC independence requirement rule were made.

If there are appropriate legislative acts in place in the country of domicile of a corporation, then the SEC allows that:

- Non-management employees may serve on audit committees;
- Principal shareholders have a representative on the audit committee. This representative will have observer status and no vote when decisions are made.
- A government shareholder representative can be on the audit committee;
- Shareholders may elect audit committee members and approve the membership of the committee as a whole (to the degree allowed by corresponding national legislation).

### **3. SOX on Internal Control**

On May 27, 2003, the SEC implemented the rule requiring domestic and foreign issuers to include in their annual reports a management report on internal controls over financial reporting. This was done in accordance with SOX Section 404.

In practice many American corporations started including these reports in their annual reporting well before the new SEC rules. It was done, however, on a voluntary basis. Since SOX made it a compulsory for corporations to submit reports on the effectiveness of their



internal controls over financial reporting, the SEC came up with the corresponding rule requiring issuers to reports on the internal control system.

The SEC rules point out the responsibility of leading persons of a corporation (CEO and CFO) to submit a report on the effectiveness of internal controls — and they have to sign the report. Another important point — SOX requires issuers to provide an independent accountants' report, which should include an attestation, an assessment of the work of the company's top management. This is a separate and different report from the audit report in compliance with GAAP.

As regards SOX provisions on functions of the Public Company Accounting Oversight Board (PCAOB), I would like to point out the following: SEC rules will require the independent auditor to describe in its audit report, firstly, the scope of its testing of the structure of the company's internal corporate system of controls over financial reporting; and secondly, the assessment of the whole internal control over the quality of financial reporting — not only of the quality of corporate audit and management's reporting.

In order to enable both American and foreign companies to prepare properly for the new SEC requirements on internal controls and audit, we plan for these requirements to come into force in July 2005.

In response to a request from American issuers, we decided against the initial idea to accelerate annual reporting deadlines for US companies from 90 to 60 days; this will be deferred for three years. For now we have set the deadline at 75 days. Foreign issuers don't have to worry about the possible acceleration of deadlines for the submission of their annual reports, as for them we have kept the deadline of six months from the end of the fiscal year.

#### **4. SOX and Independent Directors**

Before SOX, in the United States there were no legislative acts on either the federal or state level which contained the term “independent director” or stipulated their role on a board of directors, audit committee, or in other corporate governance structures. The only exception was the 1940 Federal Act, which required that independent directors represent no less than 40% of an investment fund's board.

In SOX and new SEC rules, the notion of independent director have been clarified and their roles on the audit committee and in the system of internal controls defined.

I would like to note, however, that before the conception and passing of SOX, the largest American stock exchanges — NYSE and NASDAQ — stipulated requirements for issuers in involving independent directors. Both NYSE and NASDAQ would not list a company if independent directors represented less than a half of the board of directors. After SOX was passed the largest American exchanges introduced changes to their rules which, on the whole, were aimed at further toughening requirements in the sphere of issuers' corporate governance. In other words, now NYSE and NASDAQ requirements to companies working on American stock markets are sometimes more strict than SOX or SEC rules demand. For example, both exchanges require that the compensation committees and nominating/corporate governance committees of American issuers be comprised entirely of independent directors

The requirements of SOX and largest stock exchanges regarding the membership of the audit committee are mandatory for both American and foreign issuers. But the rules of NYSE and NASDAQ regarding the membership of compensation and nominating committees apply only to American companies.

NYSE will require disclosure from foreign companies preparing to be listed of how the principles of corporate governance in the country of domicile differ from American standards as defined by SOX and the SEC and the rules of the exchange itself. NASDAQ will permit non-American issuers who want to have their shares listed on the exchange to be exempted from its requirements for American issuers under the condition that American standards differ from the laws and rules of business practice in the home country of the foreign company.

There are some other differences between NYSE and NASDAQ in what they require of non-American issuers.

## 5. Voting by Proxy

Just a few words on the changes in SEC rules regarding the procedure for nominating candidates for company directors. The current practice is such that shareholders, in principle, have the right to take part in the procedure for nominating candidates to the board. They cannot, however, solicit proxies from other shareholders.

In October 2003, the SEC proposed rules that would, under certain circumstances, allow the use of a vote by proxy mechanism when nominating directors. This proposal received many responses of both a positive and negative nature. After debates, in November 2003 the SEC introduced changes to its proxy rules in order to provide for fuller information on the actions of board nominating committees, and a higher degree of openness in consideration of shareholder nominees.

## 6. Depository Receipt Trading

You know that a company which is going to trade depository receipts on exchange markets in the USA has to go through the registration procedure with the SEC.

There are different levels of American Depository Receipts (ADRs). To be more exact, there are three levels of ADRs and also floating depository receipts according to SEC rule 144A. In the latter case, the receipts do not require registration and are floated only amongst the largest (“qualified”) institutional buyers. These operations need not regulated by SOX, as they are privately placed.

As regards level-one ADRs, to date hundreds of Russian companies have carried out transactions with this type of receipt in the USA. The good news for companies working with level-one ADRs is that they only have to fill out a really simple registration form with the SEC (Form F-6). As receipts of this level are issued only on shares already issued in the company's country of domicile, the SEC accepts the foreign company's home-country information. SOX requirements do not apply to level-one ADRs. The bad news for companies which want work with these receipts is that the SEC cannot allow issuers of level-one receipts access to American exchanges; trading these is only allowed on off-exchange markets. Companies cannot attract new capital from the main capital markets with level-one receipts.

Why does the SEC put these restrictions on level-one ADR issuers? Because we want to first make sure that companies are ready to be listed on the largest USA

exchanges. Companies working with level-two and -three receipts have to comply with more stringent SEC requirements regarding disclosure and financial reporting standards. All reporting has to comply with GAAP requirements. SOX applies to all companies with level-two and level-three ADRs. The difference between level-two and level-three ADRs is that level-two ADRs cannot be used to raise capital through additional issuance of receipts.

The five Russian companies listed and working on American exchanges submit their reports in accordance with GAAP requirements. This is why, in contrast with Western Europe corporations which use international financial reporting standards, Russian companies do not have problems with the correspondence of international standards to GAAP requirements.

## 7. Proposals Not Reflected in SOX

Some proposals offered during the drafting of SOX were not accepted. I will only mention two such proposals directly related to the corporate governance sphere.

Firstly, although in practice an increasing number of companies are separating these functions; neither SOX nor the rules of the largest American exchanges require the separation of the board chairman and the director general positions.

Secondly, SOX does not have a “one share — one vote” requirement. The recent Google IPO serves as a reminder that there is no “one share — one vote” rule in the U.S. Google issued two classes of common stock — class B shares were listed on NASDAQ, these having the rule of one share — one vote principle; company leaders retain class A shares, these having 10 votes per share.

Google is not the only example of companies with different types of common stock. Some large media companies, such as The New York Times and The Washington Post, have two classes of shares because they think this allows them to retain a certain amount of independence from shareholder influence.

### NEW YEAR'S GATHERING of INDEPENDENT DIRECTORS



On 17 December 2004, in the St. Petersburg hall of the Hotel National, a New Year's Eve party was held for the members and partners of the Independent Directors Association (IDA).

These gatherings are becoming an IDA tradition. The majority of the New Year's party guests knew each other well enough to enjoy the friendly and informal atmosphere.

This event was opened by speeches from Alexander Ikonnikov, chairman of the IDA board and Alexander Filatov, IDA executive director. It was noted that the IDA membership grew by one third in 2004. This bears witness to the growing recognition of the work of the association and its positive role in the implementation of international standards and corporate governance principles in the Russian business environment. Owing to IDA's active work and the broadening of its membership in the Russian business community, the understanding of the importance of independent directors to successful business development improved. In 2005, the association plans to continue its cooperation with the International Finance Corporation (IFC) in the sphere of corporate governance, consultation and methodology assistance to IDA members, and further broadening the membership of the association.

The informal part of the evening included a quiz and a raffle, a banquet and live music. And of course, plenty of toasts.

Over a 100 people were present at the New Year's gathering of IDA members and partners.

### DIRECTORS' MEETING IN LONDON BOARD OF DIRECTORS – EFFECTIVE GOVERNANCE INSTRUMENT

*This material was compiled by Alexander Ikonnikov, chairman of the Independent Directors Association board, based on the speeches and comments of those who took part in the meeting.*

It is no secret that leaders of Russian companies and enterprises are rather skeptical about implementing international practices of corporate governance (CG) in the domestic business environment. The Russian business reality is considered to have very clear specifics, and thus no world CG and management standards can be successfully used in our country. Interest in CG appears amongst Russian companies only when they desire access to foreign capital markets. These ambitious plans can prompt the leaders of Russian businesses to include board meeting agenda items such as financial reporting compliance with GAAP, independent directors taking part in strategy development, perfecting effective methods for the assessment of the directors' and managers' input to the results of the company's work, and other similar points which are regularly considered by boards of international companies.



There would have been fewer supporters of this point of view if they had taken part in the two-day meeting of Russian and international businessmen and representatives of professional organizations, which was jointly organized in London on 20-21 September in London by the British company Hanson Green and Amrop Hever Group Russia with the support of the Independent Directors Association (IDA).

In contrast to many events abroad with representatives of the Russian business elite, this event did not turn into a pseudo-academic forum where university professors and business school teachers were trying to teach “new” directors from the far away country of Russia the principles of civilized corporate governance. The podium was given almost entirely to practitioners — active directors who have many years of experience working in companies and organizations of various profiles, sizes and spheres of industry. Quite quickly it was established that in the corporate governance sphere, British and American companies have encountered and still encounter many of the problems which are current for Russian business.

The role of shareholders in a public company's business development; corporate governance quality and criteria for the recruitment of board members; assessment of the input from independent directors; development of the long-term strategy and seeking the balance of interests;



## Who Spoke?

During the September meeting directors discussed over 20 speeches of board chairs and members of well known multinational and British companies — London Stock Exchange Plc., Eurotunnel Plc., Thales UK Plc., JP Morgan Investment Bank, Deutsche Asset Management, Delta Plc., BG International Plc., Hanson Green, and others.

The list of speakers at the London meeting on corporate governance was comprised of leaders with rich experience in management positions. For decades these people have encountered numerous problems at different stages in a company's development and have found solutions to these problems. Amongst the speakers were:

- **Mike Bishop**, head of British and European equities department at Morley Fund Management.
- **Nigel Stapleton**, chair of Uniq Plc., chair of the company managing the British Royal Mail Service, Postal Services Commission.
- **Peter Brown**, member of the Independent Directors' Committee in the British Institute of Directors. Globally known expert on issues of motivating and awarding board members and company top managers.
- **Paul Manduca**, regional director for Europe, Deutsche Asset Management.
- **Hugh Aldous**, board chairman of RSM International. He is a recognized expert in the sphere of accounting and audit investigations.
- **Tony Hales**, non-executive director for Reliance Security Group Plc. and Aston Villa Plc.
- **Lord Freeman**, board chairman, Thales UK Plc. Member of Parliament 1983 - 1997.

stimulating and awarding directors and managers; measures for the protection of the company against hostile mergers; principles for the recruitment of leading personnel — this is just a partial list of the talks at the London meeting. Virtually all aspects of corporate governance were considered with the use of real examples of the highs and lows of British and American corporations. Those who spoke managed to demonstrate to the participants that CG really does play the most important role in the everyday life of a company that wants its business to develop successfully. Corporate governance is not a problem which has to be adopted by companies now and then when a crisis arises; CG is an inseparable element of a company's organization — as important as production, sales management or staff recruitment.

All speeches were split into following topics — Corporate Governance: Challenges Encountered by Companies; Urgent Issues for a Board Meeting; Board Efficiency; Advisory Council Role; Issues of Corporate Governance Compliance with Legislation of USA and Great Britain. Case studies were also presented; they illustrated business development situations of companies lead by strong and weak boards of directors.

It was stressed in the speeches that over the last 15 to 20 years, the key points in the sphere of corporate governance changed significantly in Great Britain, USA and Western Europe. In the 1980s managers and executive directors played the key roles in organizing and managing the corporation's business. Now shareholders are playing an increasingly important role. They demand higher efficiency, precise strategic and tactical decisions, a considered approach to motivating top managers, balance in the relationships between different investor groups, transparent reporting, and independent audits. By assuring these conditions, in the shareholders' opinion, corporations can provide for stable development and high dividends, as well as avoiding financial scandals and other trouble.

In general, many analysts positively assess the higher degree of shareholder involvement in the business of British companies. To a certain degree the increase in investor involvement was a reaction to the series of financial crashes and large scandals involving some leading British public companies in the end of the 1980s and the first half of the 1990s. In Great Britain after these events the regulating influence of the state in the corporate governance sphere grew, some changes occurred in companies' approaches to the membership and structure of boards of directors, and the balance changed in the relationships between boards, top management and shareholders.

Amid increasing pressure from shareholders, the role of independent directors in the corporate governance system became significantly more important. First of all,

requirements for board chairs (this function in Great Britain is more and more often carried out by a non-executive director) became much more stringent. These requirements are related to the professional qualities and experience of the leader, his ability to understand the strategic goals of the corporation, and his ability to interact with other board members and top managers. British studies of board activities in different companies show that over the last few years the average number of issues being considered at board meetings has risen significantly, and the average duration of board meetings has correspondingly increased. The personal responsibility of the board chair for decisions made has also grown.

In Great Britain the effectiveness of boards' decisions and activities has grown in comparison to what was typical for British companies in 2000 or 2002. However, the increased workload and degree of responsibility of board chair and members is rarely commensurately compensated .

One of the consequences of the scandals involving large British companies due to errors and improper practices in the corporate governance sphere (Mirror Group Newspapers, Maxwell Communications, and Headington Investments could serve as examples) is the increased shareholder and regulating authority attention to the size and the structure of awards received by company directors and top managers.

In the beginning of the 1990s the Cadbury Committee reached some conclusions which served as the foundation for current British corporate governance standards. In regard to the principles of compensating directors and top managers, the committee pointed out the necessity of including complete information about the size and structure of board members' income in a company's annual report, as well as the necessity of the compensation committee reporting to shareholders at annual general meetings. In 1995 the Greenbury Committee clarified some statements regarding the principles of compensation of independent directors of British companies made in the Cadbury Committee report. Then finally in 1998, the London Stock Exchange (LSE) introduced changes to its listing rules. The new rules reflect the main approaches of the Cadbury and Greenbury Committees to directors' and managers' compensation. LSE requires that, in public corporations or companies whose shares are going to be floated on an exchange, directors' awards have to be approved not by the compensation committee (as was stipulated by the Cadbury and Greenbury reports), but by boards of directors. On top of this LSE listing rules include a point on the independent status of the board's chair or of the existence of a senior non-executive director on the board (in those companies where the chairperson is not an independent director).

These changes in the approach to directors' compensation have undoubtedly played a positive role in terms of pre-

venting financial impropriety. At the same time there is no common practice for the assessment of the directors' and top management's input amongst British companies. The prevalence of subjective approaches to assessing the input of separate board members has led firstly to a large diversity in the remuneration of directors and managers in companies of similar size and operating in the

### What are awards committees in British companies?

In 2003 British consulting firm Independent Remuneration Solutions conducted its second survey of independent directors (the previous survey was conducted in 2000). Apart from questions involving the conditions and size of independent directors' compensation, questions about the specifics of the organization and the work of compensation committees in British companies were asked. Two hundred eighty-three compensation committee members were included in the study. The survey yielded rather interesting findings, which were broadly commented on in the British press during 2004. Some of the results of the survey are listed below:

- 39% of compensation committee chairs, who were classified as inefficient, were appointed either because they were the oldest among candidates or because they had served as non-executive directors for the longest time.
- The majority of compensation committee members did not have fixed-term contracts; of those that did have such contracts, the term was usually for three years.
- Large companies paying chairs and members of compensation committees usually had the following rates of pay: for chairs — GBP 5,000 — 6,000 per annum; for committee members — GBP 2,000 — 4,000 per annum.
- More than a half of committees had three or more independent directors as members.
- 93% of compensation committee members in British companies did not receive any special training before or during their work in the committees.
- More than a half of all compensation committees took into account the opinions of independent consultants in their decision making process. But one fifth of those committees considered ineffective did not take into account the recommendations of independent consultants.
- In 43% of cases, annual reports drawn up by awards committees were signed only by the committee chair and not by the members.

same segments; and secondly to strong pressure from company leaders on board chairs and compensation committee members.

As regards assessment of the work of the top-management team, those speaking at the meeting said that this assessment should be based on the indicator of effectiveness of the use of the invested capital (return to shareholders) and not the return growth. Applying the criterion of the effectiveness of “work” of own capital of company compels managers to consider the business of the company from a proprietor's point of view, thus stimulating their responsibility in decision making to focus on the long-term interests of the company and shareholders.

The topic of awards is inseparably connected to the question of what exactly the shareholders and the chair of the board expect from board members. What is an “ideal director” in a modern company?

In short the main duties of the “ideal” director are well known: firstly, he has to do right by the shareholders, providing for the long term stability of the company's business and the high indicators of capital returns (which, in its turn provides for the high dividends to shareholders); secondly, he must manage the business of the company, seeking strategically important spheres and key aspects of the work of the company; thirdly, he should constantly monitor the work of the management.

The effective CG system is always based upon the principle of the priority of the shareholders' long-term interests. An “ideal” director should focus on upholding this principle, should be able to manage a constructive dialogue with the shareholders in order to be able to find the company's business strategy, and the ways and means of putting this strategy into reality.

There are less clear criteria for the assessment of professional and personal qualities which a director should possess if he is to fulfill the functions listed above. There are many opinions on this matter: often the highest importance is assigned not to the director's professionalism or experience, but to his qualities as a leader or his ability to foresee (predict) the development of the situation, or the ability to win the trust of managers and shareholders. People who spoke at the London meeting expressed the opinion that the key quality of an “ideal” director is his grasp of business. This means that he should have ready answers for the four most important questions in the life of a company: 1) What direction is the company moving in, and what strategy should be designed and implemented for that?; 2) How would you define real growth in the value of the company and what tools and methods should be used to increase it?; 3) what criteria and indicators best reflect the degree to which the company, and some

of its personnel groups (directors, top managers, employed staff) achieve the strategic goals; 4) what is happening in the company right now.

Issues involved in recruitment of and drawing up qualifications for directors were analyzed in some presentations. One of the founders of Hanson Green, Peter Waine, formulated the criteria for recruitment and assessment of non-executive directors. In Waine's opinion, a good non-executive director should have the following qualities:

- 1) Be able to see the company through difficult times;
- 2) Assist the effective work of the board of directors;
- 3) Provide for continuity when directors and top managers change;
- 4) Understand the psychology of the board chair;
- 5) Be able to clearly and plainly explain his ideas, thoughts and opinions before board members and top managers.

What mistakes should be avoided by companies when recruiting independent / non-executive directors?

The practice of Hanson Green proves that many British companies make same mistakes when choosing candidates for non-executive directors. For example proprietors and managers of British companies often want to get persons known in business who have achieved stunning successes in their careers as non-executive directors. People forget to take into account the fact that these successes might have been achieved purely by accident, or by sheer luck. One should not exclude well known people as candidates to the board, but it should be taken into account that they may have lost their enthusiasm and stimuli to carry out their duties responsibly.

Another typical mistake of British companies when choosing candidates for non-executive directors is the drive to get people who recently retired on the board. These people are prepared to hold their positions on the board for a long time, and appear to be working "making noise", but there is no real benefit from their "sitting" on the board.

From the point of view of the chairman of the board, one of the common mistakes is appointing a person who is a good friend, an acquaintance, or a relative to be a non-executive director. This person can hardly be considered independent, and it will be hard to manage him and to effectively assess his work.

From the point of view of board members it would be wrong to appoint as the board chair a recently appointed non-executive director. There should be continuity in the company, with well-thought-through planning of the

process for replacing board members and other leaders of the company.

Many British companies (as, possibly, companies in other countries) thought for a long time that they could single-handedly, without assistance from professional recruiting firms, find qualified non-executive / independent directors. Lately, however, British businesses, especially large corporations, more and more often resort to professional help when looking for candidates to fill director positions. Recruiting firms which specialize in the recruitment of non-executive directors (an example of this type of company in Britain is Hanson Green) can help their customers establish the professional skills and personal characteristics of candidates.

Companies' need for strong non-executive / independent directors will grow as their significance on boards of directors and for the company's business as a whole increases. Howard Thomas, Dean of Warwick Business School, quoted one famous US corporate governance expert who asserted that independent directors should be the "window to the world" for the management of the company, and that executive directors should look on the "inside of the company".

There are new elements which have appeared lately in the corporate governance structure of American and European companies. One of these new elements is the advisory board. Usually an advisory board consists of eight or nine people who meet several times a year to discuss the key aspects of a business and give their recommendations to the proprietor, directors or top managers. Advisory boards have no legal responsibility (either collective or personal) for expressed opinions and recommendations. Members of these boards are more open than members of the board of directors or of other committees in the corporate governance system. In many ways these boards have the same function as independent consultancy firms, however, they know the specifics of the company's business, corporate governance system, and professional and personal qualities of directors much better.

The September meeting of directors in London had a wide resonance in the British media and specialized publications. Russian participants of the meeting noted the exceptionally high level of presentations and the excellent organisation of the event. The wish to continue the discussion of such important CG issues as the effectiveness of the board of directors, relationships with shareholders, and the role of non-executive / independent directors was expressed.

IDA is planning to continue taking part in these meetings to further the exchange of opinions and experiences in the CG sphere between Russian and foreign directors.



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## «RUSSIA CORPORATE GOVERNANCE MANUAL»

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