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Corporate Governance and Efficiency of Russian Companies from Stock Market Perspective

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CORPORATE GOVERNANCE AND EFFICIENCY OF RUSSIAN COMPANIES FROM STOCK MARKET PERSPECTIVE

Abstract

The article shows that a transition from a static to a dynamic analysis of corporate governance changes of the definition of "corporate governance" to include not only relationships between a company and its shareholders, but also company relationships with a variety of other stock market participants. The article analyses corporate governance's level of influence on company efficiency. It also suggests a minimum set of key corporate governance principles, by examining which company meets compliance with most well-known principles of corporate governance. The conclusions are illustrated using case studies of Russian companies.

1. Introduction

As a result of a rapid development of the world financial crisis, conflicting views on corporate governance arise. Some say that the virtual (stock market) economy brings more damage than benefit (look at the financial crisis), and, therefore, corporate governance which actually links virtual and real economy should be demolished. Others note that the financial crisis as nothing else has convincingly showed the influence of problems of virtual economy on the real one, and, therefore, proved the importance of corporate governance. Finally, there are some researchers who claim that irrespective of the level of corporate governances all companies were hit drastically and, therefore, the level of corporate governance did not play any role at all. Although, their opponents insist that even if this was the case, then those companies which have better corporate governance will recover much faster.

Analysis of corporate governance in different countries shows that each country experienced formation of its own national system of corporate governance which has its unique features.[1,2] Although, what is common for all of them is the fact that corporate governance is the relationship between the company and the stock market, or to be more precise, stock market participants which are interested in the company's securities (we will return to the definition later). Corporate governance system provides access for market participants to adequate information about the real economics of an enterprise. In turn, the company expects that good corporate governance will allow it to attract financial resources from the stock market on favourable conditions, get regular and sufficient access to capital, and ensure a more stable shareholders base, which will result in a stable capital structure of the company.

Efficient corporate governance envisages involvement of corporate governance into routine management procedures of the company. External attributes of corporate governance, like regular financial reporting under International Accounting Standards, regular interaction with market participants, non-executive directors, etc., should be combined with the restructuring of internal corporate management system. The company should consider spending necessary resources for corporate governance activity. Decisions made by the management on key issues should be well justified and be ready for scrutiny by market participants. At any moment, the management should be ready not only to make a decision, but also justify it to market participants and convince them that it is the best decision for the company. This type of behaviour is essential both at good and bad times for the company. The management should be able to address the causes of negative results of the company and be able to propose a program of improvement of the company's activity. Finally, there should be regular contacts of the management with market participants. In other words the management should feel like they are behind the rostrum in front of an interested audience.

One of the issues arising in discussions is whether corporate governance influences the economic efficiency of the company? This issue turned out not to be thoroughly analysed. This paper is dedicated to analyzing this issue.

Emergence of corporate governance in Russia about 15 years ago confronted researchers, lawmakers and management with a set of issues which are still far from being resolved even today. The problem of transition from the dominant state socialist property to a

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[1] Rafael La Porta , Florencio Lopez-De-Silanes & Andrei Shleifer. Corporate Ownership Around the World. Journal of Finance, Volume 54 Issue 2, Pages 471 – 517, Published Online: 17 Dec 2002

[2] R.I.Kapelyushnikov. Concentration of Ownership in Corporate Governance System: evolution of understanding. Rossiisky Zhurnal Menedzhmenta (Russian Journal of Management). 2006. Vol. 4. № 1. pp. 3-28.

domination of private property, from the planning economy to a market-based economy, has been mainly solved in the dark, because nobody had relevant experience of such transformations. Meanwhile, the story was aggravated by the fact that the system corporate governance worldwide experienced a deep crisis. The cases of Enron, Parmalat, WorldCom, etc. raised serious questions on the efficiency of corporate governance institutions in developed countries. Therefore, one can outline two major classes of studies which could be used for addressing the issues of corporate governance in Russia.

The first class of studies consists of a conceptual analysis of corporate governance problems stemming from the classic paper of Berle and Means[3]. The second class consists of various papers with an empirical analysis of processes related to corporate governance. Here, it is necessary to note papers by La Porta, Lopez-de-Silanes and Shleifer, who scrutinized the privatizations in Eastern Europe in early 90s and identified major trends of these processes[4], and the research of Dyck, Volchkova, Zyngales[5], which analyzed the relationship between corporate governance and a set of public institutions[6]. It is important to mention a pivotal paper of George Kleiner[7] who introduced the term “nanoeconomics” and showed how institutions of “the economics of individuals” make a crucial impact on the life of both economic objects and other economic institutions.

During the last 10 years, several active research groups have been formed, dealing with corporate governance. Among them the group led by A.D. Radygin and R.M. Entov[8],

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3 Berle A.A., Means G.C.The Modern Corporation and Private Property. Chicago: Commerce Clearing House, Inc., 1932. See also a seminal study by Monks R.A.G., Minow N. Corporate Governance**,** Wiley, 2008.

4 R., López de Silanes, F., Shleifer, A. and Vishny, R.W. (2000) Investor Protection and Corporate Governance. Journal of Financial Economics 58: 3-27.

5 Dyck A., Volchkova N., Zingales L.. The corporate governance role of the media: evidence from Russia, Item #3 RESEARCH SEMINAR IN LAW, ECONOMICS, AND ORGANIZATION Professors Bebchuk, Hart, and Kaplow, October 10, 2005, http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/L&E-mon.10.10.F05_Zingales.pdf.

6 Ickes B.W., Gaddy C.G. Russia's Virtual Economy, World, Economy, Russia, BRICs, Global Economics, Brookings Institution Press 2002.

7 George Kleiner. Nanoekonomika (Nanoeconomics). Voprosy Economiki (Issues in Economics), 2004, № 12

8 A.D.Radygin, R.M.Entov, A.E.Gontmaher, I.V.Mezheraups. Economic and legal factors and limitations in development models of corporate governance (Research Papers of IEPP № 73). Moscow: Institute of

who classified in their papers the enforcement of shareholders' rights, the relationship between various groups of shareholders resulted from the privatization in Russia. T.G.Dolgopyatova with associates for a decade has been conducting polls of executives of Russian enterprises which resulted in a piece research on concentration of ownership and corporate control [9, 10]. A joint Russian-Japanese study on Russian enterprises led by Dolgopyatova and Iwasaki[11] analysed trends of integration of business structures and the intention of Russian companies to take part in globalization and world specialization. A.E. Shastitko clearly demonstrated drawbacks of the existing legislation which on the one hand, does not provide enough protection for good faith shareholders and on the other hand – provides a wide range of tools for bad faith shareholders to use weakness and bias of the legal system and law enforcement agencies[12]. S.Guriev with co-authors addressed the issue of demand for corporate governance, factors which influence the management decisions in corporate governance area[13]. A. Yakovlev not only classified the stages of development of corporate governance in Russia[14], but also analyzed the question of corporate governance's influence on corporate restructuring. V.E.Dementyev made a significant contribution to the

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Economics in Transition, 2004; A.D.Radygin, R.M.Entov, I.V.Mezheraups. Problems in enforcement of shareholders' rights (Research Papers of IEPP № 41) , Moscow: Institute of Economy of Transition, 2002

[9] T.G.Dolgopyatova. Ownership and corporate control in Russian companies during intensification of integration processes, Rossiisky Zhurnal Menegementa (Russian Journal of Management). 2004. T. 2. № 2. C. 3-26;

[10] V.V.Golikova, T.G.Dolgopyatova, B.V.Kuznetsov, Yu.V.Simachev. Under ref.: A.A.Yakovlev. Demand for justice in corporate governance sphere, Moscow: GU HSE, 2004.

[11] Dolgopyatova T., Iwasaki I. Exploring Russian Corporations: The First Results of Joint Japanese-Russian Project. Working paper WP1/2006/01 — Moscow: State University — Higher School of Economics, 2006. — 88 p. (in Russian).

[12] A.E.Shastitko. Problems of Corporate Governance and ways of their resolution in corporate legislation. Rossiisky zhurnal management IRuusian Journal of Management). 2006. T. 4. № 2. C. 3-24

[13] S.Guriev, O.Lazareva, A.Ruchinsky, S.Tsuhlo "Demand for modern standards of corporate governance in Russian private sector ". M.: TsEFIR, 2002; S.Guriev, O.Lazareva, A.Ruchinsky, S.Tsuhlo. Corporate governance in Russian Industrial Sector (Research Papers IEPP № 86) Moscow: Institute of Economy in Transition, 2004.

[14] A.Yakovlev. Corporate governance, restructuring of enterprises and initiatives of owners. http://www.recep.ru/phase4/en/sem/20020426/Incentives_for_Owners_Russia_Paper_Rus.pdf

analysis of the behavior of large scale financial-industrial groups[15], the attempts to change their corporate governance, analyzed a different trend in the development of corporate governance of big conglomerates in various industries. Japanese researcher T.Shiobara managed to identify some trends which probably had been left out of radars of domestic researchers and to compare the level of Russian corporate governance with other countries[16]. A researcher from Hitotsubashi University Ichiro Iwasaki analyzed the existing organizational and legal structure of Russian enterprises and those opportunities and limitations which are imposed by this structure[17].

Common for the majority of these studies is a treatment of problems of corporate governance as consequences of relationship between the management and shareholders. Nevertheless, as we believe, the real picture is more complicated and reflects the relationship between the company and stock market as a whole. These circumstances, to our mind require a broader definition of corporate governance itself.

We suggest a new variant of a definition of corporate governance based on a systems and dynamic approach to relationship between a public company and the stock market. We would like to investigate the relationship between the level/quality of corporate governance and the economic efficiency of Russian companies and also suggest a minimum set of key basis principles of corporate governance by compliance with which a company could comply with the most well-known principles of corporate governance. The conclusions are illustrated with case studies of Russian companies performed in late 90s-early 2000s.

2. Toward a corporate governance definition

According the most famous definition, *corporate governance* is the system of relationships between the management and shareholders of a company[18]. However, this definition seems to be too narrow to reflect some aspects of the co-activity of the owners and shareholders, which is important for them both, and, therefore, needs systematic expansion.

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[15] V.E.Dementyev. Investment and innovations benefits of financial industrial groups // Economic and Mathematical Methods. Issue. 2. 1996.

[16] T.Shiobara. Corporate governance in Russia // Economic science of modern Russia. - 2006. - N 2. - C.108-122

[17] Ichiro Iwasaki, Corporate Law and Organizational Choice: Open and Closed Joint Stock Companies in Russia. – Hitotsubashi University, April 2006. – 20 pages. http://www.nccg.ru/site.xp/050056051053124.html

[18] See: http://www.investorwords.com/5483/corporate_governance.html

First of all, it would be better to go away from the term “shareholders” for describing of the parties the company deals with on the stock market and replace it with “investors”. Investors are economic subjects which either are already shareholders of a given company or could become shareholders in the future (potential shareholders). The extension of categories of subjects which are influencing a company is very important and, in fact, defines a new research perspective. The case is that subject to the market conditions, the performance of the company, many investors by buying and selling the company’s shares are migrating from the current shareholders to potential ones and back. As a result of this dynamics, the company deals with both the actual shareholders and potential ones. What is important is that the list of the current shareholders is known, while the list of potential shareholders is practically uncertain. Therefore, by moving away from the term “shareholder” to “investor” we are making a transition from a static to a dynamic analysis of corporate governance.

The universe of actual shareholders is not uniform either. From the point of view of the relationship with the company usually there is the following classification:

– controlling shareholders;

– blocking shareholders;

– minority shareholders.

They could be grouped using two criteria: the level of influence and their composition.

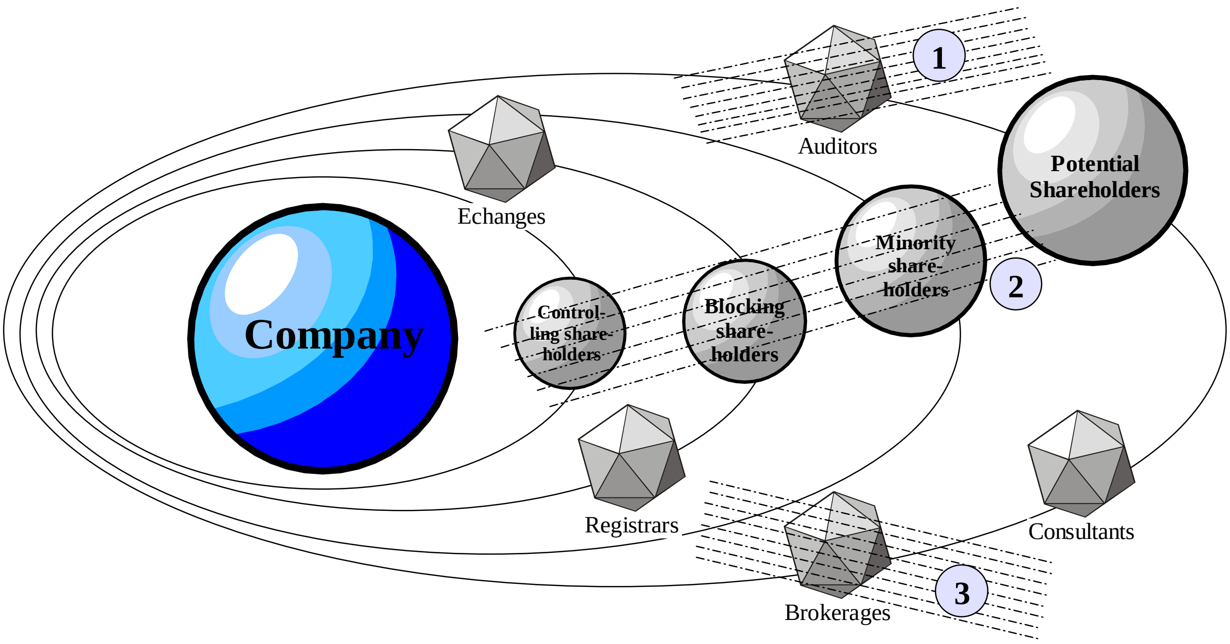

Fig. 1. Public company on Stock Market («Planetary Model»)

1 – Audit Institutions; 2 – Corporate Law Institutions; 3 – Licensed Institutions

Fig. 1 describes corporate governance as a Planetary Model which depicts a segment of the stock market from the stand-point of the issuing company ("the planet"). The group of stake-holders looks like spheres ("satellites") which revolve around the planet company on various orbits. The diameter of the sphere depends on a relative strength of this type of investors vs. the others (the bigger the share of equity capital represented by a specific group of investors is, the bigger the diameter of the sphere representing this group is). The distance/orbit between the planet company and a group of investors (satellites) depends on how strong the influence on the planet company, the stronger is the influence, the closer the orbit of a satellite is.

Secondly, in constructing a relevant definition of "corporate governance", it is important to bear in mind the importance of other subjects of the stock market. In order to make investment decisions, to cut transaction costs and optimize the structure of investments, investors attract various categories of market intermediaries and also use various institutions. The first category (market intermediaries) consists of professional brokerages, consultants, analysts, auditor companies, rating agencies and stock exchanges. They are shown on Picture 1 as "asteroids". In general, they interact both with the market participants – satellites - and the planet company.

The behavior and relationship between various market participants and intermediaries are regulated by various formal and informal institutions which in their turn comprise the environment in which issuers, investors and intermediaries are functioning. Those institutions include the institute of securities (norms and regulations which regulate issuance of new securities, turnover and cancellation of securities); legislation on joint stock companies, the federal institute of regulation of securities market (The Federal Financial Markets Service (FFMS)), which in turn includes the institute of licensing professional market participants, reporting requirements, exchange regulations, etc). Business practice is an important informal institution. On Fig. 1, those institutions (which form the stock market environment) are shown as "nebulae".

The relationship between the company and its actual shareholders plays a special role in the company's functioning. It consists of three major processes. Firstly, according to the rules which are set up by corporate governance institutions, shareholders have certain power which is materialized via general shareholders meetings and the Board of Directors. Secondly, each shareholder has the right to request certain information from the company regarding the status and performance of the company. The company in turn has the right for information about nominal and, in some situations, beneficial owners of its shares. Thirdly, ownership of shares grants shareholders the right for dividends.

Thus, the picture of "the world of corporate governance", as we understand it, is a system of relationship between a company and subjects and objects of stock market. It is exactly this system that needs to be reflected in a definition of corporate governance.

The only thing which is needed to finalise the new definition is to clarify the nature of this relationship:

- *Managerial flows (decision making flows),* from shareholders to the company;
- *Information flows*, bi-directional;
- *Financial flows* which are also bidirectional.

Managerial decisions from shareholders are related to hiring the management, nomination and election of members of the Board of Directors, a choice of auditor and formation of control procedures. Information flows from the stock market to the company reflect the evaluation of the company's performance by stock market participants and expectations regarding the future performance of the company. Information flows from the company to the stock market should on the one hand meet the shareholders' requirements for managerial decisions, on the other hand – address information requests of investors (including both actual and potential shareholders) and other market participants and help to form positive market expectations regarding the company. Information flows have a direct impact on financial flows from the stock market in terms of investments and debt financing and on financial flows from the company in terms of dividends and share buyback.

Now we could formulate the following definition which reflects the dynamic relationship between the company and the surrounding corporate environment. *Corporate Governance is a system of relationship between a public company and the stock market which defines: a) managerial efforts directed from shareholders and their groups to the company; b) financial flows between the company and the stock market; c) information flows between the company and the stock market.*

Such extended definition of corporate governance provides a systems picture of the corporate world and helps to develop new recommendations for its improvement.

3. What benefit good corporate governance brings

After the mass privatization there were hundreds of thousands of joint stock companies. According to Skrin Agency, currently there are about 73 thousand open joint stock companies[19]. In accordance with data on the 400 biggest companies in 2006[20], about 60% of total production is produced by open joint stock companies. Joint stock companies have from several shareholders to several hundred thousand shareholders (until recently, Gazprom , Sberbank and RAO UES were the most populated, etc). Many of them have their shares traded on stock exchanges, their shareholders participate in general shareholders meetings and are interested in the company's performance, elect the Board of Directors and Audit Committees. Many market participants regularly publish studies on publicly traded companies. The majority of these events take place irrespective of whether the company itself (to be more precise, its management) wants it or not. However, it is the character and result of these processes and measures and the level of efforts of the management to improve the relationship with market participants that determine the quality of corporate governance of the company.

The stock market not only plays a key role as a party in corporate governance relationship, but it is the main mechanism in the evaluation of the quality of corporate governance. Comparable companies with a higher level of corporate governance are usually valued much higher and have a higher market capitalization than similar companies with a low level of corporate governance.

According to the poll conducted among investors by McKinsey, 85% of market participants believe that in evaluating companies in Eastern Europe the level of corporate governance plays the same or even a higher role than their financial performance. Even more impressive is the following fact: 73% of investors investing in Eastern Europe are ready to pay a premium for companies with efficient corporate governance and the premium which investors are ready to pay for Russian companies with good corporate governance is as big as 38%[21]. «Russia has a strategic goal to become a country which produces competitive goods and services. However, investors are not rushing to make long-term investments into Russian companies and are pointing out that the major reason for that is an unsatisfactory level of corporate governance», — in this way President Putin characterized the situation with corporate governance during the World Economic Forum in October 2001.

From a practical standpoint, the improvement of corporate governance first of all means that shareholders, including the management and employees who are often

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[19] www.skrin.ru.

[20] Expert Magazine: 400 biggest companies in 2006 (http://www.raexpert.ru/ratings/expert400/2006/).

[21] Sebastian Molineus (project manager at IFC (the investment division of the World Bank Group). Corporate Governance Problems in Russia. (http://www.executive.ru/publications/aspects/article_1642/)

shareholders of the company, get a real benefit from the appreciation of the company's shares. Secondly, the company gets wider opportunities of raising debt capital because banks usually in making due diligence evaluate the equity/debt ratio and the bigger is the equity, the more debt can be raised. Thirdly, (which is probably a key for the future development of the business) the company gets the opportunity of issuing new equity and to attract new investments into the company. New shares in their turn could be a good currency for mergers and acquisitions. It is important to stress that in accordance with our extended definition of corporate governance the above-mentioned benefits (especially the second and the third one) envisage cooperation with a wide range of market participants and professionals and is not limited to shareholders' relationship only.

It should be noted that for many years Russian companies virtually had no opportunities of attracting investments: after the 1998 default, Russian companies could not rely on attracting either debt and equity financing. Nevertheless, since 2000 the situation has changed, first on the debt market and then on the equity market (See at Fig. 2).

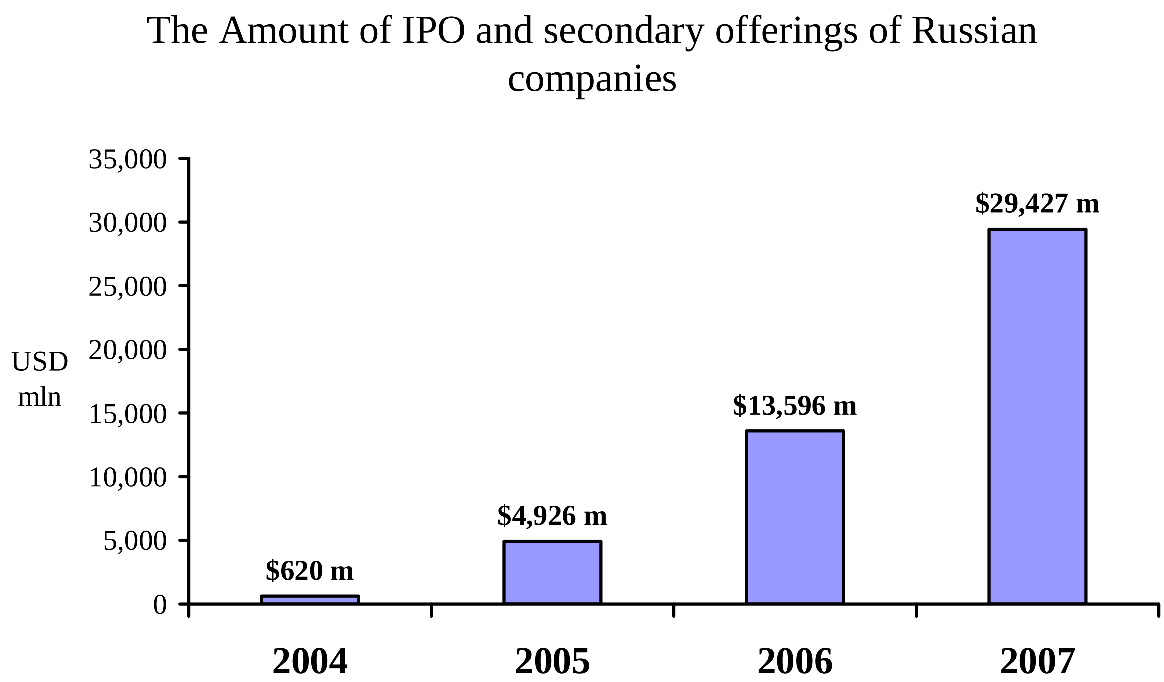

Fig. 2. The Amount of IPO and secondary offerings of Russian companies in 2004-2007 (Sources: Alfa-bank, mergers.ru)

The growth in the amount of raised capital is truly impressive. During just a four-year period, the amount increased 47 times and reached USD 29 billion in 2007 or twice as much as in all the previous years.

All this allows one to come to a conclusion that the quality of corporate governance is an important factor reflecting the status of the Russian economy.

4. Major issues in corporate governance in Russia

If one tries to classify the problems of corporate governance in Russia, one would identify the following categories:

1. Multilevel corporate corruption.
2. Conflicts of interest of the management and shareholders.
3. Conflicts between groups of shareholders, unequal treatment of minority and majority shareholders with respect to their influence on the company and access to information.
4. Conflicts between the ownership rights and hiring rights.
5. Imbalance between rights and responsibilities for major categories of economic subjects involved in a company's activity.
6. Illegal and unethical methods of realization of interests in inter-corporate conflicts and corporate raids.

As analysis has shown, there are three major sources of existing problems of corporate governance.

The first one reflects a conflict of interests of various groups involved in corporate governance. Mismatch of interest of employees and the management, the executives and mid-level management; the management and shareholders; various groups of shareholders (in particular, controlling and minority shareholders) make a complicated structure of stable goal-oriented oppositions. These relationships in their turn result in multilevel corporate opportunism, corruption, imbalanced decision making.

The second source is a result of the complexity of management of modern enterprises as such. Sometimes, in making various managerial decisions, shareholders are not sufficiently competent or informed to make a reasonable choice.

The third source is *imperfection* and drawbacks of both *legal* (property rights protection) and *informal corporate governance institutions*. Numerous examples of illegal seizure of enterprises with the use of state institutions (courts, bailiffs, law enforcement agencies) show the weakness of state institutions and the fact that they can hardly play the role of independent, impartial institutions which regulate market activity, but on the contrary, often taking sides with one party to a corporate conflict. This behavior proves the lack of public control and supervision over state institutions and also shows significant drawbacks in their administration. Informal institutions of corporate governance like the National Council for Corporate Governance and the Association for Protection of Investment Rights, because of both a conflict of interests between the members and low public recognition, could not secure the stability of property rights either. As a result, one could witness a imbalance between the rights and responsibilities of participants of corporate life and the appearance of new corporate conflicts.

5. Basic principles of "good" corporate governance

What are the criteria of the quality (level) of corporate governance? The direct evaluation of corporate governance quality is provided by the stock market itself through the share price. However, this is a mixed and complex evaluation, because it depends not only on the level of corporate governance, but also on the industry results, other companies' performance, the country risk level, etc. Indirect (non-market) evaluation of the quality of corporate governance is based on verification on whether the company complies with certain requirements (principles of corporate governance).

Based on above-proposed extended definition of corporate governance, we suggest the following three basic principles, by complying with which a company could ensure a high quality of corporate governance.

Basic Principle 1. A c*ompany seeks long-term appreciation of its expected value per share on the stock market. The expected value per share is taken to mean the liquidation value of the company divided by the number of shares (value per share).*

Let us illustrate this principle with an example. Suppose, there is a telecommunications company which, apart from the core business, owns several buildings and the brand name of a mobile phone producer. If the company's shareholders decide to liquidate the company, then they could sell separately the telecommunications business (based on the value of comparable businesses using P/E, EV/EBITDA, etc.), then sell the real estate at a market price and then – the brand name. This would bring the maximum value for shareholders.

It should be noted that maximization of company capitalization which is often used as a criterion of the quality of corporate governance does not seem to be appropriate, because capitalization itself (a short-term valuation) depends on many factors outside of the company universe: the share price of other comparable companies, the performance of the industry, the stock market dynamics, etc. During the lifetime of a company, its value experience significant variations, but it fluctuates around a long-term expected liquidation value, which should be maximized by the company through a high quality of corporate governance.

This principle is concerned not only with the company, but the stock market in general as a collective subject of decision making. Strategic management decisions (which are within the scope of shareholders' authority) should be made based their impact on the appreciation of company's value and its attractiveness for investors – potential shareholders. Each shareholder or investor who at some point was, is or will be a shareholder is willing to get the maximum benefit from the ownership of the company's shares. The company in its turn wants to maximize its own value: it increases the asset size via growth and development, generates more profit which is either paid to shareholders or invested in the growth of the company's assets.

In terms of the "planetary model" on Fig.1, the essence of this principle could be described as moving forces which make the company to increase its value (the centrifugal arrows on Fig.3). Potential investors seek to become actual ones, actual shareholders are trying to increase their participation (centripetal forces stimulate movement from one orbit into another).

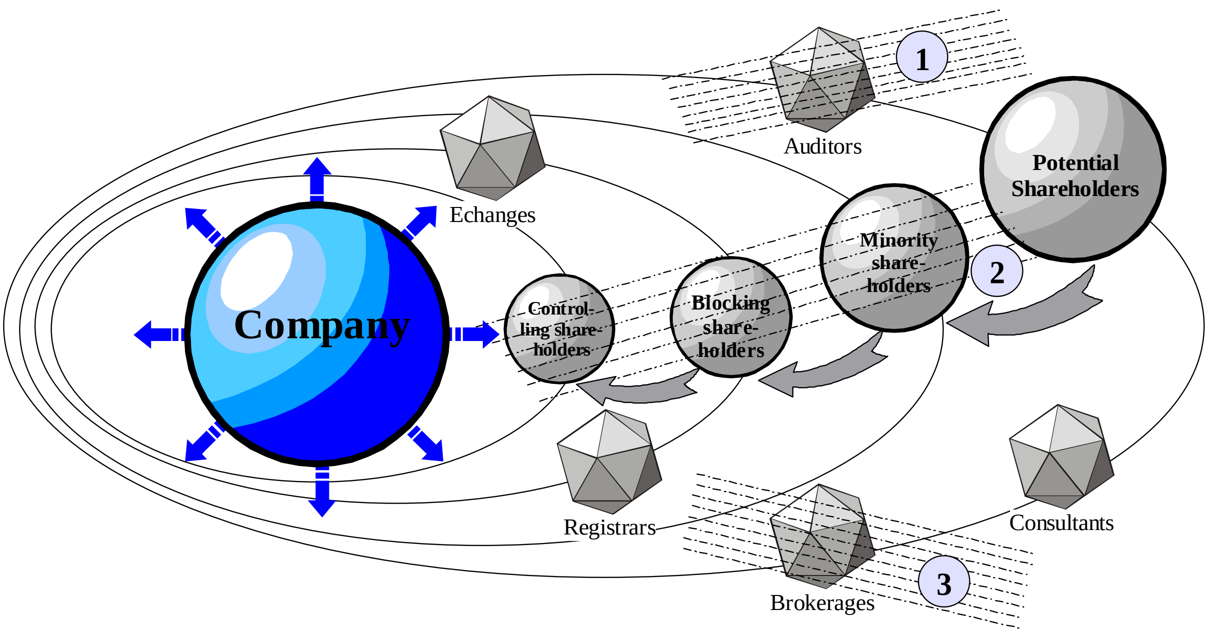

Fig.3. Realization of Basic Principle 1: moving forces of stock market

Basic Principle 2. A c*ompany's management is interested in the appreciation of expected long-term value per share of the company for investors and does not have incentives different from this target.*

This means that the management should be stimulated in such way that its activity will target basic principle 1. In other words, shareholders should choose the management keeping in mind this criterion, link the management's performance to the shareholders' goal and make strategic decisions which ensure a growth of the company's expected long-term value. A properly stimulated management can send the right information signals to the stock market, which improves market perception, understanding of company's strategy and processes. The feedback from the market will allow the management to fine-tune the management process.

In the "planetary model" context, it means that the management is sincerely interested in the growth the planet company and does not pursue the idea of building next to it its own "personal" planet, which would be developed at the expense of the planet owned by shareholders.

Basic Principle 3. A c*ompany's shareholders have equal rights per share. The controlling shareholders and the management should not make decisions which will disfranchise any other categories of shareholders. They also should not disfranchise potential investors.*

In relation to shareholders, it means the following: as soon as an investor became a shareholder of the company she gets the same right per share irrespective of what orbit she is on relative to the planet company. Although shareholders are granted some special rights after reaching some thresholds: 2% (the right of putting items on the agenda of shareholders meetings), 10% (the right to call an extraordinary shareholders meeting), 25% (the right to block some key company's decisions), nevertheless, any share in whatever package it would be, whatever shareholder possesses it gives its shareholder the same dividends or the same voting power. Those shareholder's rights which are indivisible and not additive, for example, access to information should be provided to all shareholders irrespective of the amount of shares he owns. In the same manner, potential shareholders should have equal rights to information irrespective of the amount of shares they want to buy. As a result, the market gets the opportunity to value shares as a homogeneous good, because the expected value per share does not depend on who owns them. Within the framework of the proposed "planetary model" it means homogeneity and isotropy of space around the planet company.

Let us consider how these basic principles correlate with famous principles of corporate governance. The Corporate Governance Code of FFMS[22] includes the following principles[23]:

- Shareholders have a real possibility to exercise their legitimate rights associated with the ownership of company's shares;

- The Board of Directors is responsible for strategic management of the company's activity and ensures effective control over executive bodies of the company, and the Board of Directors is accountable to general shareholders' meeting;

- Executive bodies of the company manage the company's day-to-day activity responsibly and in good faith, they are accountable to the Board of Directors and general shareholders' meeting;

- A company timely disclosure of material information about its activity including its financial and economic performance, ownership and management structure;

- Guarantee of employees' right provided by the law, development of partnership relationship between the company and its employees in tackling social problems and regulation of working activities;

- A company's active co-operation with investors, creditors and other stakeholders for the purpose of appreciation of the company's assets, share price and other company's securities.

It should be noted that some of these principles are insubstantial ("Shareholders have a real possibility to exercise their legitimate rights…") or not concretely defined ("active co-operation", "responsibly and in a good faith"[24]). The remaining principles are in fact the reflection of above-proposed three basic principles. Thus, the separation of authority between the Board of Directors and the management, control over management activity correspond to Basic Principles 1 and 2. Timely disclosure of information regarding the company corresponds to Basic Principle 3.

The OECD's list of principles looks more comprehensive and covers five areas:

1. Shareholders' rights

A corporate governance structure should protect shareholders' rights.

2. Equal treatment of shareholders

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[22] The Federal Financial Markets Service (FFMS)

[23] Corporate Governance Code of FCSM. http://www.nccg.ru/site.xp/055054051124.html

[24] These principles are taken from common law, while in civil law and the Russian legal system it does not impose any practical limitation or lead to any consequences.

A corporate governance structure should ensure equal rights for shareholders including minority shareholders and foreign shareholders. All shareholders should have the possibility for effective protection in case of violation of their rights.

3. Role of stakeholders

A corporate governance structure should recognize their rights envisaged by the law and encourage their active co-operation to create more jobs, ensuring wealth and financial stability of enterprises.

4. Disclosure of information and transparency

Corporate governance structure should ensure a timely and accurate disclosure of information on all key issues relating to the company, including financial and operational performance, ownership of the company.

5. Responsibilities of Board of Directors

Corporate governance structure should ensure that the Board of Directors should build effective control over the company's management activity, as well as the accountability of the Board Directors to shareholders.[25]

Analysis shows that these principles are also derived from three basic principles with the exception of the role of stakeholders. With respect to this matter, we share the opinion that stakeholders (interested parties) without any doubt influence the company and are a significant factor of the institutional environment. However, we do not include this relationship into the framework of corporate governance. As defined above, corporate governance describes the relationship of the company with current and potential investors, with participation of various stock market intermediaries, which influences the functioning of the stock market. Many of them are not stakeholders of the company, however, they make serious impact on the corporate governance of the company. Therefore, although the relationships between the company and its employees are important for the company, they are not part of corporate governance.

The most advanced list of principles is provided by the International Corporate Governance Network (ICGN). The following list gives their compressed version[26]:

1. CORPORATE OBJECTIVE– SHAREHOLDER RETURNS

1.1 *Optimizing Return to Shareholders*. The overriding objective of the corporation should be to optimize over time the returns to its shareholders.

[25] OECD Corporate governance principles. http://www.oecd.org//daf/governance/principles-ru.pdf

[26] See: http://www.icgn.org/organisation/documents/cgp/revised_principles_jul2005.php

1.2 *Long Term Prosperity of the Business*. To achieve this objective, the board should develop and implement a strategy for the corporation which improves the equity value over the long term.

2. DISCLOSURE AND TRANSPARENCY

2.1 *Objective*. Corporations should disclose relevant and material information concerning the corporation on a timely basis, in particular meeting market guidelines where they exist, so as to allow investors to make informed decisions about the acquisition, ownership obligations and rights, and sale of shares.

3. AUDIT

3.1 *Accounting Principles*. The ICGN supports the development of the highest-quality international accounting and financial reporting standards.

3.2 *Audit Independence*. The audit should be carried out by independent, external auditors who should be proposed by or with the assistance of, the audit committee of the board. Shareholders should have the right to expand the scope of the audit.

4. SHAREHOLDERS' OWNERSHIP, RESPONSIBILITIES AND VOTING RIGHTS AND REMEDIES

4.1 *Unequal Voting*. Corporations' ordinary shares should feature one vote for each share. Corporations should act to ensure the owners' rights to vote. Divergence from a 'one-share, one-vote' standard which gives certain shareholders power disproportionate to their equity ownership should be both disclosed and justified.

4.2 *Shareholder Participation in Governance*. Shareholders should have the right to participate in key corporate governance decisions, including the right to nominate, appoint and remove directors on an individual basis as well as the external auditor and the right to approve major decisions

4.3 *Shareholders' Right to Call a Meeting of Shareholders*. Every corporation should provide holders of specified portion of the outstanding shares of a corporation, not greater than ten percent (10%), with the right to call a meeting of shareholders for the purpose of transacting the legitimate business of the corporation.

4.4 *Shareholder Resolutions*. Jurisdictions should enact laws which provide shareholders with the right to put resolutions to a shareholders meeting which may be either advisory to the board of directors or may be binding upon the board of directors depending upon the criteria which must be satisfied by the shareholders putting the resolution.

4.5 *Shareholder Questions*. Shareholders should be provided with the right to ask questions of the board, management and the external auditor at meetings of shareholders, including questions relating to the board and questions relating to the annual external audit. In addition, shareholders should have the right to receive and discuss the annual audited financial statements of the corporation.

4.6 *Major Decisions*. Major changes to the core businesses of a corporation and other major corporate changes which may in substance or effect materially dilute the equity or erode the economic interests or share ownership rights of existing shareholders, including major acquisitions and major dispositions and closures of businesses, should not be made without prior shareholder approval of the proposed change.

4.7 *Duty to Vote*. Corporate voting systems should be designed to enable institutional investors to discharge their fiduciary obligation to vote their shares.

5. CORPORATE BOARDS

5.1 *Duties of the Board*. The board's duties and responsibilities and key functions, for which they are accountable, include those set out below:

1. Reviewing, approving and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
2. Monitoring the effectiveness of the company's governance practices and making changes as needed to ensure the alignment of the corporation's governance system with current best practices.
3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
4. Ensuring a formal and transparent board nomination and election process.
5. Monitoring and managing potential conflicts of interest of management, board members, shareholders, external advisors and other service providers, including misuse of corporate assets and abuse in related party transactions.
6. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

5.2 *Independent-Minded Directors*. One of the principle features of a well-governed corporation is the exercise by its board of directors of independent judgment. Independent judgment means judgment in the best interests of the corporation free of any external influence that may attempt to be or may be or may appear to be exerted on any individual director or the board as a whole.

5.3 *Related Party Transactions*. Every corporation should have a process for reviewing and monitoring any related party transaction.

5.4 *Director Conflicts of Interest*. Corporations should have a process for identifying and managing conflicts of interest directors may have.

6. CORPORATE CITIZENSHIP, STAKEHOLDER RELATIONS AND THE ETHICAL CONDUCT OF BUSINESS

6.1 *Board Responsibilities and Duties in Relation to Stakeholders*. The board is accountable to shareholders and responsible for managing successful and productive relationships with the corporation's stakeholders.

6.2 *Employee Participation*. Corporations are encouraged to develop performance-enhancing mechanisms which align employee interests with shareholder and other stakeholder interests.

6.3 *Corporate Social Responsibility*. Corporations should adopt and effectively implement a code of ethics and should conduct their activities in an economically, socially and environmentally responsible manner.

6.4 *Integrity*. The board is *responsible* for determining, implementing and maintaining a culture of integrity.

This list is much more comprehensive and could be more entitled to claim to cover all major aspects of corporate governance. Nevertheless, these principles either give a detailed version of basic principles or represent auxiliary principles which have a much lesser impact on the level of corporate governance. Thus, the first principle of ICGN correlates with the first basic principle. The second and fourth principles ensure the basic principle of equal treatment of shareholders. The third and fifth principles address basic principle 2 regarding shareholder control over management. And only the sixth principle goes outside of scope covered by basic principles, however, its implementation without others could not bring a high level of corporate governance.

Let us consider each basic principle in detail. The first principle says that a company is interested in maximizing the expected value of the company for shareholders. As it has been already noted, sometimes this principle is interpreted as maximization of net profit. However, in reality, a company, like any living mechanism, goes through various stages of its development. S-type theory of development of technologies could be applied to the development of corporations as well. At the initial stage of its development (expansion or intensive growth stage) the value of general volume/sales growth factor prevails over the profit growth factor. If a company prioritized profit maximization, it would jeopardize its growth. At the next stage, when the company "picks up speed", there is a moment when maximization of profit is closest to the eventual goal of maximizing shareholder value. Then, the saturation period comes, rapid growth stops and appreciation of the company's value requires additional costs for supporting the market share, technology advantages, etc. So at the aging stage of corporation the company probably needs additional investment in supporting its market power which does not correspond with short-term goal of maximization of profit. After that, there are different possible scenarios of further development of the company, which could envisage its sale, merger, expansion or even transition to a new S-trajectory along which the company should move to maximize shareholder value.

The second principle envisages that management is employed by shareholders for the purpose of maximizing shareholder value and does not have its own, significantly different goal. Management compensation is structured in a way to incentivize management to achieve the result required by shareholders. However, managing a company is a skill in itself, a combination of science, experience and art. On top of that, the management process of a big corporation gives to the management of the company access to significant assets and resources, many times bigger than the management's wealth or even future wealth promised by shareholders. Therefore, at least for a certain period of time, the management considers itself to be a body on which the company's future depends. Historically, it so happened in Russia that the role and possibilities of a company's general director in Russia are many times bigger than the significance of all other stakeholders of a company, and quite rarely are bounded enough to keep the management's activity within the framework envisaged by shareholders[27]. As a result, management builds its own interests which determine its behavior and prevail over shareholder interests in the management's mind. Among such interests could be simple enrichment at the expense of the company and its shareholders; stripping the assets for the benefit of a new company owned by the management; making decisions which ensure a prosperous future for the management after completion of their term. Clearly, these incentives are in conflict with shareholders' interests.

The third principle says about relatively equal (per share) rights of shareholders of the company. This means that from the economic stand point, all shareholders are equal and receive economic benefits pro rata to their ownership and there is no discrimination of one type of shareholders in favour of others. Nevertheless, the history of privatization in Russia and further development in 1990-2000 shows that many fortunes were made when controlling shareholders who possessed 50%+ shares in public companies had the opportunity to squeeze 99% economic benefits from the company disproportionately to their participation. But this

[27] George Kleiner. Economy of Russia as economy of individuals. Voprosy Economiki (Issues in Economics), 1996, No. 4.

type of behavior encourages minority investors to leave the Russian stock market, therefore, implementation of the third basic principle is key for future development of the Russian stock market.

6. Mechanisms of realization of "good" corporate governance

The development of corporate governance of Russian enterprises shows that reality deviates from all the three basic principles. However, a long struggle of the most active minority shareholders for their rights and the interest of the public at a certain stage in changing the situation, resulted in a formation of a certain mechanism of checks and balances, which diminishes the pressure of stakeholders on the company's corporate governance. These mechanisms are directly linked with the extended definition of corporate governance, because they imply a company's relationship not only with shareholders, but with the widest range of investors and professional market participants (See Fig.1). These mechanisms are shown in Fig. 4.

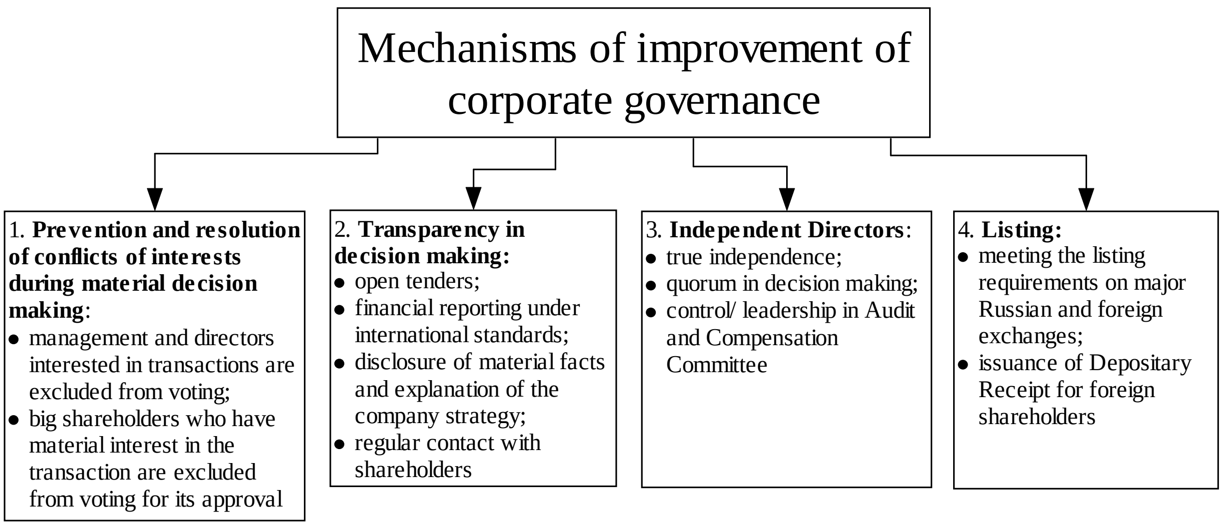

Fig. 4. Some mechanisms of realization of corporate governance principles

1. Prevention and resolution of conflicts of interests during decision making which has material financial impact on the company. This mechanism is realized by exclusion from voting managers and directors of the company having an interest in the counterparty of the transaction in question.

2. Transparency in decision making. This mechanism is realized by, first of all, open tenders. Ideally, there should be such independent organizers of tenders, whose reputation would prevent taking an unfair decision during the tenders (some kind of Christie's or Sotheby's). Secondly, it is important to have regular and timely publication of financial reports under international accounting standards. Today, IFRS and GAAP are the most well-thought out standards of financial reporting respected worldwide, which provide the most transparent picture of a company's financial activity to shareholders and also is a usual instrument for its analysis for market participants. Reporting under international financial standards on the one hand is a basis for decision making, on the other hand, it helps to evaluate the results of decision making in previous periods.

3. Wide use of the institute of independent (non-executive) directors[28]*, their participation in decision making on key issues for the company.* The existence of independent directors does not solve all the problems by itself. At the same time, a gradual growth in the status of the institute of independent directors with simultaneous improvement of their accountability and disclosure of information on how independent directors make their decisions will impact the improvement of corporate governance.

4. Listing on major Russian and foreign exchanges. This procedure usually requires a new level of transparency of the company and brings about new requirements as to the size, quality and timeliness of information disclosure. Listing on an exchange is a result of complying with the requirements set by professional investors, verified by time and practice. Releasing such information in the way required by exchanges also allows to evaluate the market response and correct the company's behavior accordingly in order to comply with the basic principles of corporate governance.

7. Influence of quality of corporate governance on a company's economic efficiency

During the making of the Russian stock market, many executives of Russian companies considered corporate governance as a kind of window dressing which allows them to change shareholders' and sometimes the market attitude towards the company, which would result in the growth of the company's share price, more opportunities of getting cheaper equity or debt capital. At the same time, understanding the corporate governance in its narrowest meaning, distinct from the above-described one, they tried to convince and meet

[28] http://www.corp-gov.ru/projects/indep.php3

the requirements not of the whole market, but a very limited group of investors (closest orbits on Fig.1), who were the most influential shareholders of the company.

There are many examples of how “polishing the skin” by very basic methods (hiring a well-trained English speaking investor relations manager, employing foreign managers and issuing nice-looking annual reports, etc.), companies failed to receive expected returns from the stock market. This happened on the one hand because by targeting a selected group of shareholders, the company left the rest of the market participants unaware about its changes, but on the other hand, which is more important, the market disregarded these changes because it considered them as only surface changes. Soon after it became clear that in order to meet high standards of corporate governance it is necessary to change the *whole management structure*. A company which aims at a high level of corporate governance, should be ready for an open and honest dialogue with a wide range of market participants (all orbits of market participants spinning around the planet company), which includes not only shareholders, but also other market professionals who influence investor decision making. The company’s management should regularly meet with market participants, be ready at any moment to explain the company’s strategy and how it is implemented. Each serious management decision should be justified and appropriately presented to the market. At the same time, the management should expect that market professionals (some of them has decades of experience in company analysis) will put under scrutiny both strategic and tactical decisions of the management. Therefore, there should be information exchange between the company and the stock market (not shareholders only). Only this type of dialogue could attract new investors and sustain long-term interest from the stock market.

But it became clear that in order to have all this information on a permanent basis (continuously) and that which could withstand the scrutiny of the market, a significant reshaping of a company’s management structure is required. In particular, part of this system should be a thorough analysis and detailed discussion of decisions to be made. Those significant transactions which are made without tenders or which could be loss-making could immediately be under scrutiny of market participants.

Therefore, in the current environment of formation and development of a stock market in Russia, it is necessary to speak about a radical reorganization of the decision-making process in Russian companies, incentives for the management, achieving a new level of accountability of management for decisions made and their implementation. Such reorganization of companies’ management structure caused by the need to improve corporate governance will simultaneously lead to improvement in the economic efficiency of enterprises.

What happened to Russian companies which lacked such type of mechanism will be considered using historical cases of three Russian companies from different sectors of economy: Gazprom (the gas sector), Apatit (fertilizers) and Volzhanka (confectionary).

1) «Gazprom»

In December 1999, during the trip of Gazprom's CEO to Turkmenistan and his meeting with the then President Niazov a long expected contract for supply of 9.1 bcm of Turkmenistan gas to Gazprom was signed, which the latter needed to fill the gap between the gas supply and demand. However, as it became clear from a RF Audit Chamber's report[29], the immediate benefit from this agreement was obtained not by Gazprom itself, but an intermediary called Itera. The chain of gas supply looked as follows. Turkmenistan gas was first acquired by Itera and then immediately re-sold to Gazprom at a higher price (Fig. 5).

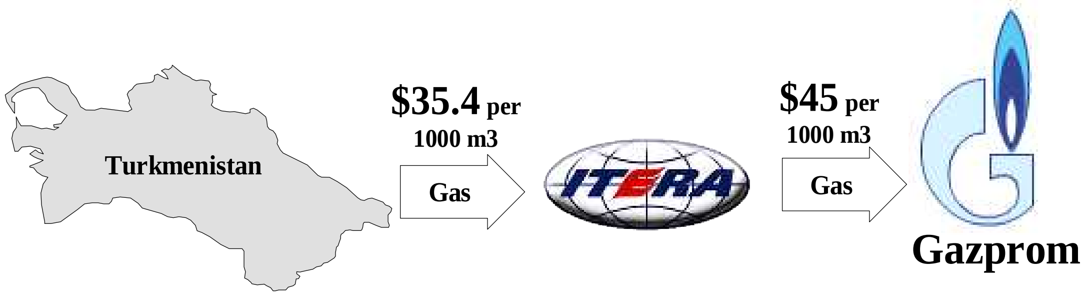

Fig. 5. Chain of supply of Turkmenistan gas

No justification for the existence of this intermediary was provided to the market. Moreover, the economic reasoning of its involvement was unclear, because Gazprom negotiated the actual transportation of gas through a separate agreement. In reality, this intermediary "cost" Gazprom US$85 mln in terms of lost profit[30]. In this case, we could see that the decision taken by the management of the company on the one hand did not comply with the first basic principle of corporate governance, because it did not maximize the company value for shareholders. On the other hand, since the decision was made by the top management of Gazprom, one could say that the second basic principle was violated as well, because the management, in deciding on this contract did not pursue the goal of appreciating

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[29] Audit Chamber of RF: Report of MGK Itera regarding compliance with Russian legislation while exploring and realizing natural gas and its relationship with Gazprom. (http://www.ach.gov.ru/results/09/17.php).

[30] V.Kleiner. Corporate governance and efficiency of company (Gazprom case study), "Voprosy economiki " - No 3 2006.

the company’s long-term value. On top of that, this decision influenced the economic efficiency of the company because the company did not receive possible, but foregone profit.

2) «Volzhanka»

Volzhanka is a well-known Russian confectionary located in Ulianovsk. After its privatization, the company faced a private controlling shareholder. In 2001, this shareholder made the company management to attract a new intermediary for procurement of input materials and sales of finished products. This intermediary was a newly formed OOO Yurprovider, which did not have any experience either in confectionary market procurement or in the confectionary products market. Meanwhile, some employees of Yurprovider were closely linked with the controlling shareholder of Volzhanka.

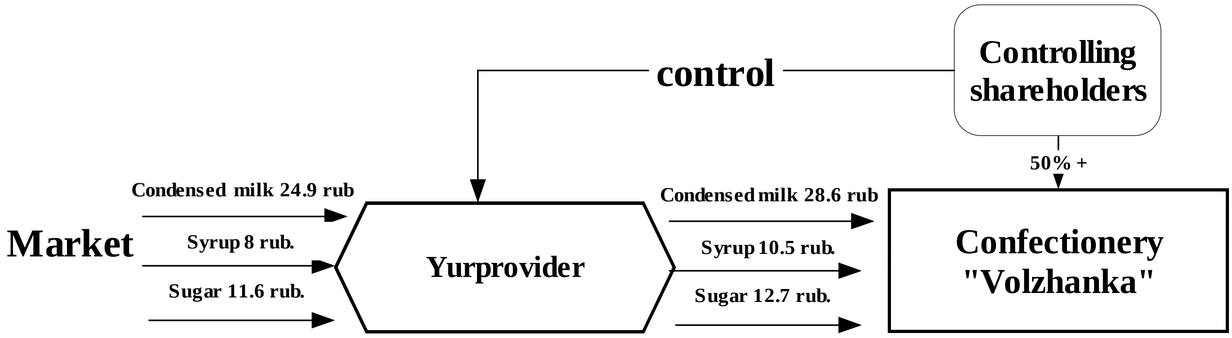

Fig. 6. Input materials supply chain for Volzhanka

The result of involving the intermediary was that the company was now paying a markup on top of the market price of input materials and spend an additional amount of about USD 110,000 a year. The case is interesting in that from the corporate perspective the controlling shareholder behaved in the worst possible manner. Firstly, it had this decision taken without informing the other shareholders, and secondly, when the latter learned about the intermediary and voiced their disagreement, the controlling shareholder continued to pursue the same policy changing intermediaries from time to time. Besides, this decision had a direct impact on the company’s performance, since the company was now losing quite significant amounts through intermediaries’ markups. In this case, all the three basic principles were violated. Firstly, the company was losing a «possible income», secondly, the management had to take decisions contrary to the goal of increasing the company’s per share. Thirdly, as a result of this scheme of supply, the controlling shareholder gained greater value per share than the other shareholders.

3) OAO Apatit (open joint-stock company Apatit)

An investigation of the system of management of OAO Apatit carried out by the RF General Procuracy in 2000-2202[31] revealed a management scheme whereby a significant part of the apatite concentrate produced by the company was sold to intermediaries affiliated with the controlling shareholder at prices lower than the then market prices. As a result, the company lost around USD 200 mln of income within the period in question (See Fig. 7).

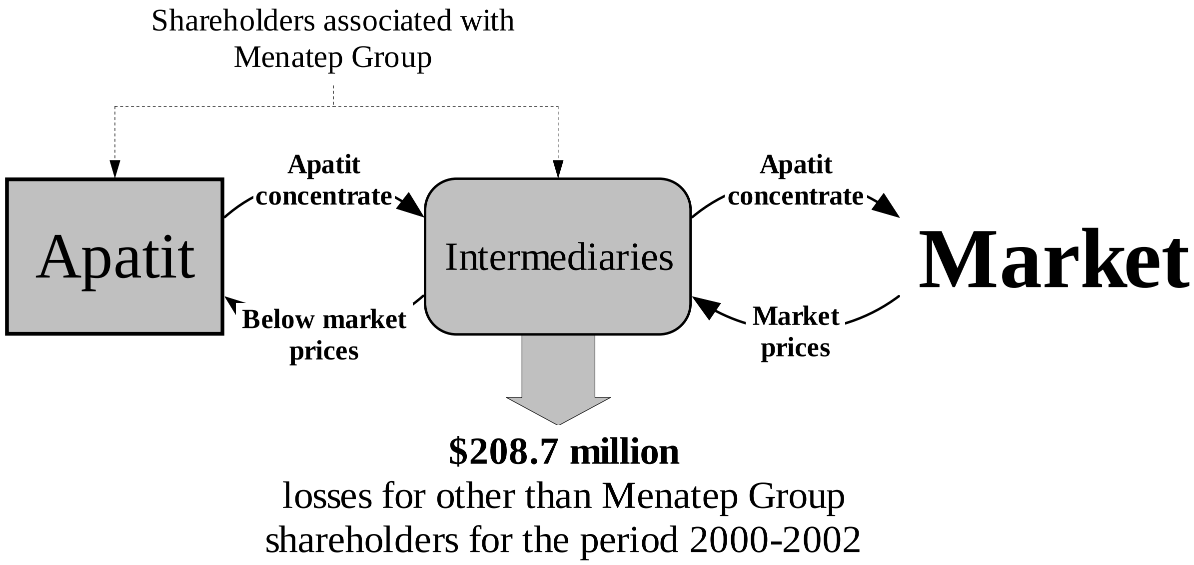

Fig. 7. Scheme of supplies of apatite concentrate to the market

Thus, one can see here a case of “bad” corporate governance, where the controlling shareholder actually ignored the rights of the other shareholders to a significant part of the company’s revenue. The result was not just a significantly lower level of corporate governance, but also a lower performance of the company that lost sizable amount that cold be used for its development. This case also involves violation of all the three basic principles of corporate governance, virtually the same as in the previous case.

4) OAO Surgutneftegas

Surgutneftegas has for many years been a major Russian oil company. At the same time, the level of its corporate governance has for many years been rather low, which can be demonstrated using several examples.

A. Dividend policy.

[31] www.lenpravda.ru/today/251934.html

Its dividend payout policy has drastically differed from other Russian and non-Russian oil companies.

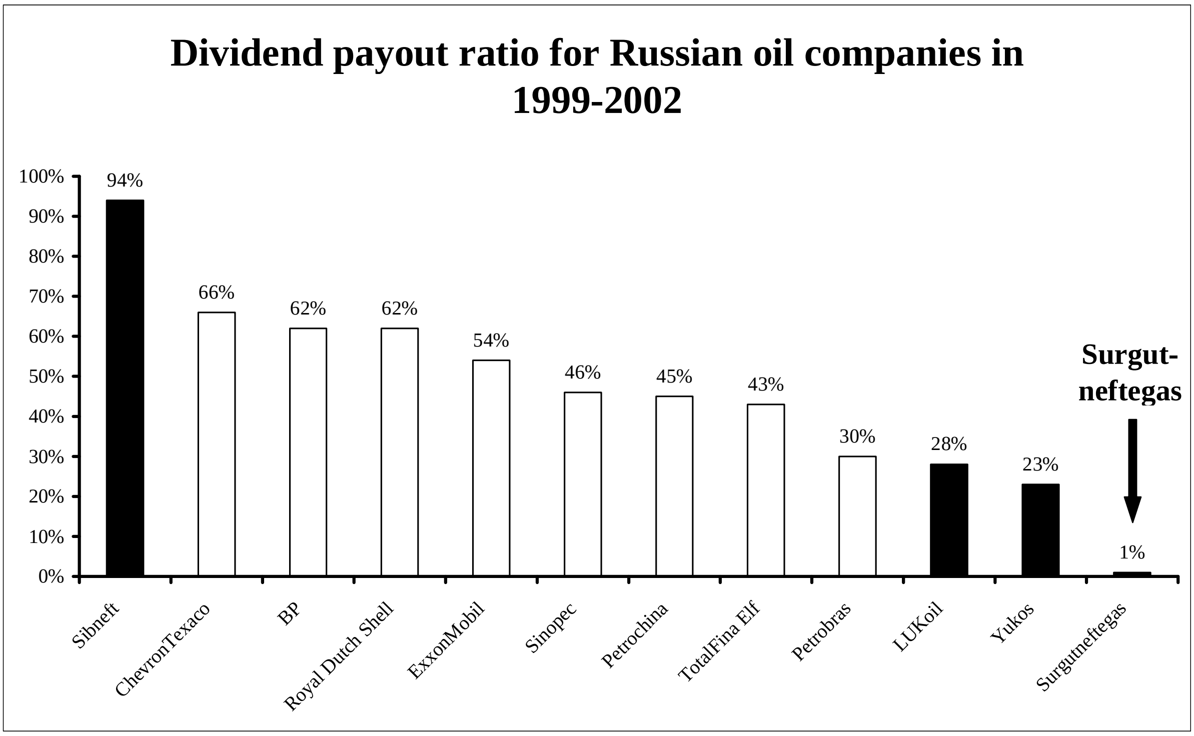

Fig. 8. Portion of oil companies' income in 2002 paid out as dividends.

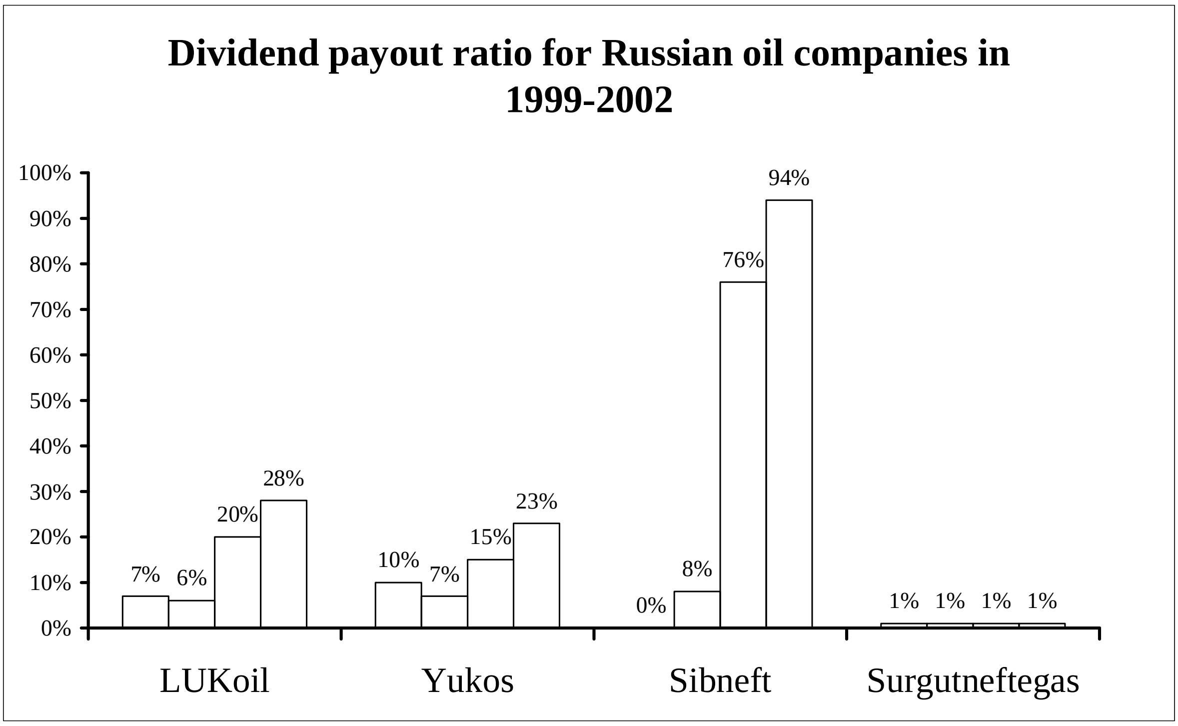

Fig. 9. Portion of Russian oil companies' income paid out as dividends in 1999-2002.

Besides, this policy was sustained for several years at a time. (See Fig.9).

The company's management, no doubt, has the right to propose to its shareholders a company development plan whereby the portion of the income paid out as dividends would be minimum, with the remaining income used for investment into production and refining or acquisition of new assets. However, the situation where dividend payout, from year to year, has constituted a significantly lesser portion than the industry average, and the company's income has not been invested, but is retained in the form of cash that is not paid out to shareholders and not invested, such policy violates the first basic principle of corporate governance since it is not geared to a long-term growth of the company's share price. More than that, since this has been the management's deliberate policy, one can speak about the violation of the second basic principle – with the management pursuing its own interests different from those of the shareholders.

B. Financial reports under International Accounting Standards.

All the Russian oil companies began, since 1990s, to publish, on a regular basis, reporting under international standards(IFRS or GAAP). Having lived through their initial development stage, Russian corporations became participants in the international industrial-financial relations. This mainly involved their export supplies of crude and refined oil, their import of equipment and processes, hiring of experts with international experience, raising funds in overseas financial markets, raising equity capital both in Russia and overseas. This implied that the companies had to conform to the standards of corporate governance accepted overseas (or had to strive to achieve this). A factor in achieving a company's transparency and accountability is publication of financial reporting under international accounting standards. Having started with annual reports, the Russian oil and gas companies are now publishing regular quarterly reports. Yet one exception is OAO Surgutneftegas. Having once published reports for three years (1999-2001), the company declined to use international reporting standards altogether. As a result, the situation in the stock market is such that the company's share price is always discounted by the degree of "closedness" of the company. It would be now appropriate to recall the above-proposed definition of corporate governance. The case in question shows that all the market participants are, in fact, involved in the company-market relationship, and not just those who are currently its shareholders. It is, in fact, a broad range of investors who are in a position to compare not only the changes in the company's behavior towards shareholders over time, but also to compare it with other companies' attitude towards market participants.

5) Oil companies

It may seem that the above-given examples are only isolated cases which are not characteristic of the Russian economy at large or belong to the times past which are gone for ever. The analysis of the oil industry operation over the period of 2002-2004 in terms of crude oil export prices has shown that the gap between the Russian companies' crude oil export price and the Russian oil market price varied from USD 2 to 4.5. However, multiplied by the volume of the exported oil, the gap was equal to USD 10.9 billion of lost income. (See Fig. 10).

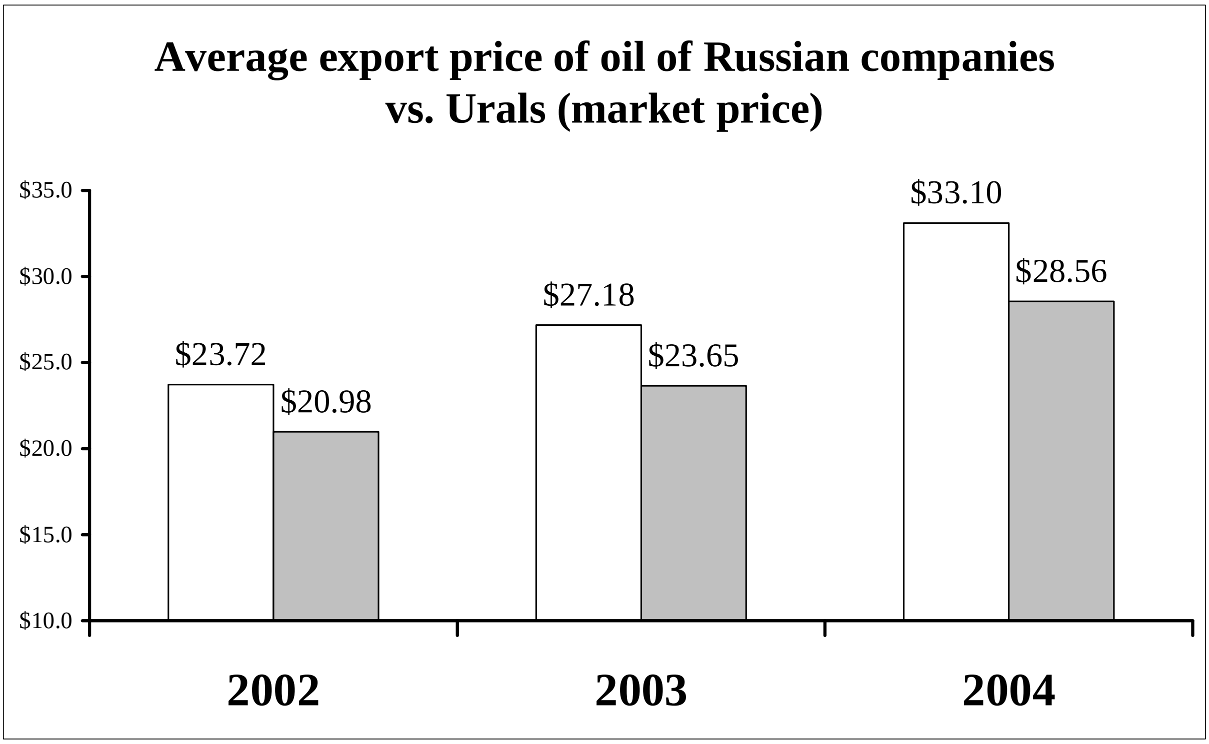

Fig.10. Comparison of world market price for Russian oil with the oil sales price according to statistical data provided by the Federal Customs Service of the RF.

Such situation occurs, as a rule, because oil companies use intermediaries in oil trade. Minority shareholders and market participants are against the use of such intermediaries. The result turns out to be negative both for the quality of corporate governance and the efficiency of Russian companies. Although such global picture does not allow one to make a definitive conclusion as to which specific principles were violated by each company, it would be reasonable to suggest that at least the bulk of the companies in the sector violated basic principles 1 and 2. The method of oil sales was not optimum from the point of view of maximization of shareholder value, and the management was making decisions having other goals in mind or at the minimum, had several goals that diverted them from achieving the goal of increasing the price per share.

8. Conclusions

The interconnection of corporate governance and company performance is much more deeply rooted than it may appear at first glance. A number of market participants – subjects of corporate governance such as company shareholders are naturally interested in enhancing the company's performance and transparency of making managerial decisions potentially having a significant corruption component. If information concerning such decisions is disclosed to market participants in a complete, accurate and timely manner, the existing and potential shareholders, and other market participants become, in fact, «wood scavengers» who subject to public scrutiny company performance, in particular, in those areas of companies' activity which are prone to corruption. Recognizing such institutional role of market participants, we impose, thereby, certain obligations on public companies. Regulator requirements on information disclosure, access of market participants to information, involvement of market participants in company management and control bodies reflect the institutional model guiding all stock market regulators. Companies as economic agents gain from its enhanced performance, since only the most efficient economic decisions are left after the "natural selection" of managerial decisions subjected to the scrutiny of market participants.

Secondly, the government should realize that it is always a market participant and should abide by the market rules. Behavior outside of these rules destabilizes the market, increases a risk component, which increases the cost of capital for market participants and thus impacts the economic performance of market players.

Thirdly, the financial crisis is no doubt going to exacerbate the deficiencies and contradictions which exist today in corporate governance. Comparisons with the 1998 crisis show that the level of corporate governance significantly goes down in a crisis, many controlling shareholders used to completely ignore the rights of small shareholders and other market participants. However, the companies which despite difficult economic conditions manage to maintain or improve their model of corporate governance, will be able not only to show a better economic performance, but to regain, before others, access to financial resources of the stock market.