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Background Paper

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Partners

MAY 2013 TECHNICAL SEMINAR BACKGROUND PAPER

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This paper collects and presents the view of a large number of foreign and international institutional investors with respect to the first draft of the updated Russian Code of Corporate Governance.

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INTRODUCTION

1. We welcome the opportunity to submit comment to the OECD-Russia Corporate Governance Roundtable regarding proposed revisions to the Russian Federation's Code of Corporate Governance ("the Code").

2. We submit the following observations and recommendations on behalf of the undersigned institutional investors and related trade bodies:

- 32 investment institutions[2] from eight countries[3] with assets under management ("AUM") totalling over US$4.9 trillion, and representing equities, corporate debt and sovereign debt with actual or potential exposure to the Russian securities market. Not included in this figure are two trade associations, Eumedion[4] and the Shareholder Association for Research and Education (SHARE)[5], with 70 and 50 members, and further AUM of US$1.3 trillion and $12 billion, respectively.

- Of these signatories, 11 institutions have been consulted in the development of the following recommendations, and are supportive of this effort, although they did not contribute detailed input to this submission.

- We also note and welcome the parallel submissions being made to this consultation by the International Corporate Governance Network (ICGN), whose collective AUM exceed US$18 trillion; and by BlackRock, Inc. (US$3.94 trillion) and East Capital International (US$5.1 billion). We wish to emphasise our shared objective to provide constructive input with a view to strengthening Russia's governance landscape and investment prospects.

3. Finally, we note that a number of institutions with AUM totalling several trillion dollars have declined to participate in this submission, despite broadly supporting its substance and in some cases having significant Russian exposure. Their absence reflects the fact that they preferred not to express their views on the record.

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[2] See Appendix 1 for full list of signatories

[3] Countries include: Canada, France, Italy, Netherlands, Norway, Sweden, United Kingdom, United States.

[4] Eumedion is the Dutch corporate governance and sustainability platform of institutional investors

[5] The Shareholder Association for Research and Education provides responsible investment advisory services to Canadian institutional investors – see www.share.ca.

GENERAL COMMENTS

4. We welcome the Russian government's aim to develop Moscow as an international financial centre, and the many important regulatory reforms that have been introduced in the furtherance of this goal:

- We note the FFMS's *Development Strategy for the Russian Market until 2020*, which seeks to advance capital market infrastructure, strengthen the legal environment, raise standards of investor protection, enhance disclosure and prevent unfair practices.

- We welcome the fact that Russia has signed Memorandums of Understanding (MoUs) with 16 countries in order to coordinate effectively with foreign securities regulators; however, we very much hope to see these efforts extended to the major financial centres of the US and UK, and underpinned by a Multilateral Memorandum of Understanding (MMOU) with IOSCO, as we believe this will give international investors confidence that strong and consistent regulatory standards will prevail.

- We note that Russia's scores in the World Bank Public Governance Indexes on indicators such as Rule of Law, Regulatory Quality and Corruption have plateaued over the last decade, and lag behind fellow BRICs and substantially behind the OECD average. Equally, we note that the World Bank's Doing Business rating of Russia stands at 112th out of 185 in 2013. We therefore welcome President Putin's goal of improving the country's ranking to 20th by 2018 and emphasise the comfort that the World Bank Public Governance Indexes provides.

- We commend the progress achieved in agreeing mutual recognition and enforcement of foreign legal judgements with several CIS countries as well as Italy and Spain. However, we regard continued advances, in particular with key OECD countries such as the US, UK and other European countries, as critical to continuing to build investor confidence through the ability to seek legal redress. In this respect, a clear emphasis on improving the strength and independence of the Russian judicial system will render reliance on foreign courts less necessary for the resolution of commercial disputes.

- To win the support of investors, such commitments will require clear evidence that the necessary practical steps are being taken to ensure the effective implementation and enforcement of the above reforms[1].

5. As investors with portfolios that span numerous and varied global markets, we accept that different markets have different characteristics and ownership structures, and that legal and historical legacies inevitably shape the business environment.

- We reject the imposition of a one-size-fits-all 'best-practice' model for corporate governance in Russia.

- We recognise that high concentration of ownership is a fact of the Russian business landscape, as is a relatively high level of state ownership. We do not see ownership structure as a problem *per se*, provided it is the subject of appropriate governance systems and behaviours.

- However, the necessary 'checks and balances' around concentrated ownership structures have been severely lacking, and have thereby undermined the attractiveness of the Russian market as a

whole. This has, in turn, fuelled a 'Russia discount' that has negatively affected all Russian issuers, including those that do not present such ownership patterns, and has spurred many to seek dual or even sole listings on overseas stock exchanges.

- Strong governance protections related to high ownership concentration is especially relevant given the Russian government's plans to undertake a major programme of privatisation, the success of which will depend crucially on strong market confidence in the proposed reforms.

6. Our inclination to invest in Russia would be significantly enhanced by credible evidence of improvements in the corporate governance and regulatory landscape.

- We believe such improvements would lead to lower risk, improved valuations, and enhanced cross-border trade and financial flows that would benefit Russian issuers and their investors alike.

- As foreign investors, we note that our concerns are echoed by domestic investors: Russia has suffered significant net capital outflows (4.5% of GDP in 2011), which look set to persist in the absence of credible reform.

7. Despite the Russian economy's highly attractive fundamentals, our specific investment exposure is affected by significant concerns about the high level of risk associated with standards of corporate governance, ownership structures, investor protections and the overall judicial and regulatory climate.

8. Our goal is to improve corporate governance in order ultimately to erase the severe discount in Price/Earnings ratios that currently increases the cost of capital for Russian issuers:

- With average 2012 P/E ratios for Russia at 5.3x, versus average figures of 16.1x, 12.8x and 10.0x for India, Brazil and China, respectively [2], the potential improvement in Russian equity valuations is significant, even if only modest progress is achieved.

9. Although framed in terms of voluntary reforms of corporate practice, the recommendations included herein depend critically on broader institutional change:

- The FFMS Code has the potential to drive important change in corporate behaviour, but this will only win the confidence of international investors if it is underpinned by a clear commitment to continuous improvement and transparency across the broader institutional, legal and business culture.

- The voluntary principles of good governance and investor protection embodied in the Code should therefore be underpinned by effective laws and regulations that evolve over time to set a globally-acceptable standard of minimum practice. The Code should thus derive its legitimacy from a clear and credible legislative mandate to drive reform.

- We note that the Code calls for companies to comply with its recommendations on a Comply or Explain basis. While we value the flexibility inherent in a comply-or-explain approach, we also caution against its limitations in an environment such as Russia's that is dominated by controlled companies. We therefore see the need for a combination of firm rules to lift minimum standards, complemented by the articulation of more ambitious, aspirational best-practice standards that companies should commit to adopt over time.

- In general, we find that the Code as currently drafted sets out a body of practice that represents a notable improvement over the 2002 Code, several of which are highlighted below. At the same time, however, the Code sets a standard that is in many respects consistent with minimum compliance below which investors would likely have significant concerns. As such, many of its

recommendations serve as a fruitful basis for legal and regulatory reform, which we hope is forthcoming, together with effective enforcement.

10. We welcome and share the goal of the Moscow Exchange in establishing a new premium market segment ("*Novy Rynok*").

- We note and share the Exchange's aim[3] to encourage "higher corporate governance and transparency requirements [...] to give comfort to investors and offset deficiencies in Russian law"[4].

- Although not, as such, the subject of this consultation, the *Novy Rynok* plays a positive complementary role to the Code, by serving as a "carrot" to companies that wish to improve their valuation by demonstrating substantive adoption of high standards, many of which are outlined in the Code, as well as in our recommendations for improvements to the Code.

- Overall, we see this Code as serving to drive consistent improvement in minimum standards across the whole of the market, even as the *Novy Rynok* sets a more ambitious objective of establishing a clearly-differentiated standard that is explicitly intended to be aligned with globally-recognised standards of good practice.

11. We see a clear imperative, if these ambitious goals are to be reached, for State-Owned Enterprises ("SOEs") to show evidence of leadership in driving the necessary reforms.

- SOEs represent a major part of the Russian economy, and must serve as exemplars by putting into practice the recommended good practice standards that the revised Code will embody.

- To earn the trust of international investors, any such commitments will require clear and credible evidence of practical change on the ground, through a combination of enhanced reporting, overhauled board accountability systems and wider legal, regulatory and judicial reforms.

12. To be genuinely effective, the Code should be applicable to all Russian listed companies, whether privately-owned or state-owned (SOEs), and all Russian exchanges.

Box 1. Comments to the Code

We note and welcome the fact that the draft Code covers all joint-stock companies.

RECOMMENDATIONS ON THE CODE

13. Our predominant concern revolves around safeguarding the interests of minority shareholders and providing them with the effective means to exercise their rights, so as to ensure that 1) powerful controlling or block shareholders operate in accordance with good governance principles, 2) minority shareholders enjoy fair and equitable treatment, and 3) minority shareholders may obtain effective redress in such cases where their interests may be at risk. Our specific recommendations and comments centre on four main topics, namely a) board governance and composition, b) transparency, c) credible minority investor protections and d) reporting against the Code:

BOARD GOVERNANCE AND COMPOSITION

1. Nomination of board directors

14. We note the relatively minor role presently played by nominations committees in the nomination of independent non-executive directors (INEDs), relative to that played by either controlling shareholders or by minority shareholders who exceed the minimum ownership threshold required to nominate a candidate for the board.

15. We therefore urge that the Code significantly strengthen the role of the nominations committee, such that it be clearly charged with driving the nominations process, for both board and executive director appointments. In this respect, it is essential that in bolstering the power of the nominations committee, the latter's independence from the controlling shareholder be strictly protected in respect of INED nominations. The Code should explicitly disallow nominations committees from taking any actions that have the effect of compromising the INED nominations process by restricting the choice of candidates to individuals who are insufficiently independent of the controlling shareholders.

16. To safeguard the integrity of the INED nominations process, the Code should further require companies to give shareholders a forum to challenge the independence of individual candidates, e.g. via the AGM and through ongoing dialogue, and be obligated to evidence such independence through the disclosure provisions noted in (17.) below.

17. The Code should require companies to issue comprehensive biographical data on all board nominees, in particular regarding the skills and attributes they will bring to the board, other roles and directorships, the nature of their relationship with the company and its major business partners, and any other potential conflicts of interest. These data must be released sufficiently in advance of the AGM to enable investors to make informed voting choices (minimum 21 days).

Box 2. Comments to the Code

We welcome the Code's recommendation (Section 2.1.4.4.3.) that nominations committees interact with shareholders in order to identify potential board candidates, and in particular the Code's explicit call for such dialogue not to be "limited to largest shareholders only".

2. Director independence

18. Given the current absence in Russian law and regulation of a clear and consistent definition of independence, we urge the Code to articulate a definition that is consistent with international best practice.

19. We emphasise the importance of combining the key principle of independence with equally critical requirements of professional competence, experience in relevant areas and a reputation for integrity.

20. We welcome the *Novy Rynok*'s proposed provision of a minimum of one-third independent directors and no fewer than three persons, provided such individuals meet the above definition of independence and overall competence.

21. However, we also encourage the Code to set a standard of at least 50% independent directors for companies with dispersed ownership; this should be a requirement within the premium (*Novy Rynok*) segment, and observed on a Comply or Explain basis in other segments.

Box 3. Comments to the Code

We note the Code's very detailed description of factors that denote board independence (Section 2.1.3), and in particular its focus on identifying and mitigating conflicts of interest; its attempt to define affiliates, controlled entities and other related parties as broadly as possible in implicit recognition of the widespread problem posed by undisclosed relationships; its emphasis on "substance over form"; and its effort to raise overall board independence by setting out a minimum proportion of one third of the board. We also note the Code's recommendation that the board chairman be an independent director and be available to communicate with shareholders (Section 2.1.4.1).

However, we caution that to win the trust of investors, this very exhaustive enumeration of independence criteria will require practical evidence that it is resulting in stronger, more transparent and responsive boards. In this respect, setting the minimum proportion of independent directors at 33%, while a good positive step, is insufficiently ambitious for companies with dispersed ownership: it should be 50%.

The Code is also largely silent on the risk posed to independence from cross-directorships (save a very brief reference to service on remuneration committees – 2.1.3.1.9); sets an overly generous ceiling (5%) on the maximum shareholding above which a director is considered non-independent.

Finally, we urge that the Code consider the other points noted below related to government-appointed Non-Executive Directors (NEDs), as these aim to strengthen the standard of independence, yet are absent from the current draft.

22. We welcome the Russian government's decision to replace ministers and other senior public officials on the boards of SOEs with external directors, and understand and welcome the fact that the ultimate goal is to increase the role of independent directors.

23. We note the transitional practice of appointing "professional attorneys" to serve as non-executive directors, and caution that these cannot be regarded as a substitute for independent directors. Given current draft legislation identifying seven areas where such professional attorneys may enjoy an exemption from professional liability, SOE boards should, to the extent this is passed, undertake voluntarily to refrain from availing themselves of any such exemptions.

3. Board committees

24. Given their omission under current law and regulation, the Code should establish a clear minimum requirement that all companies across all listing segments have an audit committee; and that all companies in segments *below* the premium *(Novy Rynok)* segment be encouraged to establish

nominations and remuneration committees over time, on a Comply or Explain basis. The *Novy Rynok* segment should make all such key committees a requirement.

25. Given the high proportion of extractive and other high-impact industrial companies listed in Russia, the Code should specifically reference the need for the board to set up a dedicated Health, Safety and Environment committee at board level.

26. All committees should be chaired by properly independent directors (see recommendations for independence above) and be predominantly composed of independent directors.

Box 4. Comments to the Code

We welcome the Code's recommendation (Section 2.1.4.4) that companies set up board committees with audit, nominations and remuneration committees, as well as "other standing and ad hoc committees" as appropriate. We further welcome the recommendation that all be chaired by INEDs, and that the audit committee be fully independent. These are major positive steps.

However, we caution that the effectiveness of these key committees depends fundamentally on their quality, independence and resourcing, as defined elsewhere in this submission.

Moreover, we note and agree with the Code's recommendation against over-stretching INEDs by limiting their involvement in too many different committees. That being the case, however, with a minimum independence quotient of only one third of the total board (or three individuals), we question how it will be possible to have a sufficient number of INEDs to properly resource fully independent audit (Section 2.1.4.4.1.) and remuneration committees (Section 2.1.4.4.2.), as well as a majority-independent nominations committee (Section 2.1.4.4.3.). This underscores the need for a higher proportion of INEDs, which, per above, we recommend to be at least 50%, especially for non-controlled companies.

4. Audit committees

27. We urge boards to establish audit committees that are properly resourced with financially-literate independent directors, and whose function is explicitly distinct from that of the revision commission.

28. Given the revision commission's entirely different purpose relative to the audit committee, i.e. its role as *de facto* agent of the dominant shareholder with no accountability to the board, we consider it critical that the audit committee have sufficient authority, independence and skill to fulfil its mandate properly to oversee the audit process, monitor and mitigate conflicts of interest and safeguard minority shareholder interests and rights, particularly in respect of related-party transactions.

Box 5. Comments to the Code

The Code contains an extraordinarily detailed set of recommendations concerning the proper functioning of the internal audit process, including explicit language concerning mechanisms to ensure its independence (Section 5.2), all of which is sensible.

However, the Code then goes on to stipulate additional detailed terms governing the revision commission (a.k.a. internal audit commission), including language purporting to link this body with the work of the audit committee. Insofar as the revision commission is widely viewed as acting at the behest of the controlling shareholder, whereas the audit committee aims to be fully independent and serve as the guarantor of minority shareholder interests, it is vital that the two maintain their distinct identities and functions. Many investors have even argued for the outright elimination of the revision commission, as its value to minority investors is not clear.

29. The audit committee should, at a minimum, be majority-independent (where independence meets the strict definition outlined above), with a financially-literate chairman and fellow members; the Code should encourage companies towards a fully independent Audit Committee over time.

Box 6. Comments to the Code

We very much welcome the Code's recommendation that audit committees exclusively comprise independent directors (sect 2.1.2.4.1); this is a major step forward.

However, we caution that the impact of this recommendation depends entirely on the rigour with which the independence definition is applied. In fact, it is preferable to have an audit committee that comprises a majority of genuinely independent and competent members than one that is nominally 100% independent but ineffectual. In this regard, we consider it inadequate to require that only one audit committee member be financially literate, and further note that the Code's definition of financial literacy is weaker than that normally regarded as necessary for this role.

We also note with some concern the minor mention made of the audit committee's oversight role of the whistleblower protection ("prevention of bad faith action on the part of employees and third parties"); and the placement of "negligence, fraud, bribery and corruption, commercial bribery and various illegal activities that are detrimental to the company" in a footnote (Section 2.1.4.4.1.4). These issues pose significant operational, legal, commercial and reputational risks and therefore merit proper attention in the Code's articulation of the board's responsibilities. We also note the Code's implicit assumption that the whistleblowing apparatus overseen by the audit committee is to be entirely managed by executive bodies; the Code ought to recommend clearly in favour of an independent externally-operated whistleblower reporting system, so as to enable effective and confidential participation.

30. Given that only 60% of the largest SOEs currently have an audit committee, we strongly urge the Code to ensure that this requirement apply as much to SOEs as to private sector issuers.

31. The audit committee should be properly empowered through explicit terms of reference to obtain candid and independent advice from the external auditors. We note the limitations under current Russian law regarding the power of the audit committee to take appropriate action for the protection of minority shareholders,; we therefore urge the Code to articulate a standard for the effective empowerment of the audit committee that is consistent with Russian law, such that the board, either itself or acting with the assistance of the audit committee, deliver the necessary level of protection to minority shareholders.

32. This includes giving the audit committee the authority to disclose areas where it has disagreed with and been overruled by the main board, while the Code should also require the main board to provide an explanation for such areas of disagreement.

33. We note the absence of any legal requirement for shareholders to approve the selection of the audit firm that will conduct the audit of the IFRS financial statements, whereas selection of the RAS auditors does require shareholder approval. We therefore urge the Code to require issuers likewise to submit the IFRS auditors' appointment to a shareholder vote.

34. We urge that the Code require the auditors explicitly to disclose any relevant conflicts of interest.

35. We recommend that the Code include a requirement related to auditor rotation, such as requiring that the audit mandate be put out for re-tender at regular intervals and/or that the individual audit partner be rotated.

36. We also recommend that the current language governing restrictions on non-audit services by audit firms be clarified through the adoption of clear guidance on the maximum allowable level of non-audit fees relative to audit fees.

Box 7. Comments to the Code

We note that the Code omits any reference to the need for audit committees to take positive steps to address and overcome conflicts of interest, including the pressure on both auditors and audit committees to suppress information. The Code also omits clear guidance regarding the balance between audit and non-audit services.

5. Risk management and internal controls

37. Boards should ensure proper oversight of internal risk controls as regards all key financial, operational and reputational risk factors. Included within this are the adoption and effective implementation of comprehensive anti-fraud, anti-money-laundering, anti-corruption and other ethics and compliance systems.

38. Particular attention should be paid to the design and implementation of effective internal reporting mechanisms (a.k.a. whistleblower protection systems), so as to ensure that employees and other third parties who report wrongdoing enjoy sufficient protection against intimidation or unfair penalties.

39. Boards should also ensure clear leadership on, and effective oversight of, robust practices related to environmental, health and safety and community relations management, to the extent that these may have a material impact on the business performance and reputation of the company. The above-noted focus on effective internal reporting (whistleblower protection) mechanisms is equally relevant in these areas.

40. In this regard, we strongly welcome the recommendation issued in 2011 by the Ministry of Finance in favour of disclosure of ecological information in financial statements. We trust that appropriate corporate disclosure of environmental, social and other stakeholder-related information, and the improved management that such transparency is likely to bring about, will strengthen companies' ability to guard against punitive regulatory enforcement actions related to such potential breaches.

Box 8. Comments to the Code

We welcome the Code's recommendation that the board "consider the interests of stakeholders, including employees, creditors, suppliers of the company and people living in the territory in which the company operates" and to respect "accepted environmental and social standards" (section 2.1.1.). We also note the explicit reference to the board's responsibility to "assess social, ethical, environmental and other non-financial risks faced by the company" (Section 2.1.2.1.) and to demand accountability from management of such risks.

Finally, we commend the Code for recommending disclosure of the company's social and environmental policy (section 6.4), reporting of its sustainable development performance in accordance with the Global Reporting Initiative, and publication of the results of its "technical audit, ... quality control systems and certification … of compliance with international standards". We also favourably note the Code's call for the Annual Report to include information on employee health and safety, training and environmental protection (Section 6.5).

6. Board control over controlled undertakings

41. It is of major practical concern that the effectiveness of the board of directors in exercising its duties is severely constrained by the fact that it typically has oversight and decision-making authority only over the company's direct activities, and not over its controlled undertakings.

42. The Code should therefore require companies to define the board's remit sufficiently broadly to address this deficiency, ensuring that the parent company board disposes of both the

necessary information regarding the activities of such controlled undertakings and appropriate decision-making authority, in particular in relation to the oversight and approval of RPTs.

Box 9. Comments to the Code

We note the Code's explicit acknowledgement that the NEDs' and INEDs' ability to discharge their duties "largely depends on the form, timing and quality of information they receive", which it candidly acknowledges "is not always sufficient to enable board members to properly perform their duties". As such, we welcome the Code's call for board members to request additional information, but most importantly for companies to commit to providing it as part of their formal written duties.

7. Fiduciary obligations for board directors

43. We regret the absence within current Russian law of a comprehensive and effective definition of fiduciary obligation for board directors that comprises duty of care and duty of loyalty. We see such a concept, in combination with robust enforcement, as an essential component of a legal framework that effectively underpins corporate accountability. Until this gap is closed, we recommend that, at a minimum, the Code establish a voluntary standard that articulates such obligations for board directors.

Box 10. Comments to the Code

We note that Section 2.1.1 of the Code requires companies to ensure that board members "act in good faith and reasonably … with due care and diligence". While this is consistent with the basic concept in current Russian law of fiduciary obligation, it stops short of providing the breadth and precision noted above, thereby limiting director obligations to a narrow set of objective duties that absolve them of the responsibility to exercise independent judgement.

44. Moreover, insofar as Russian courts have not recognised as binding the current Code's requirement governing fiduciary obligations, it is essential that the revised Code require this concept to be explicitly referenced via a clear contractual obligation in director contracts.

45. However, we caution that in light of broader concerns regarding the enforceability of contractual agreements, such a soft law approach to strengthening fiduciary obligations will inevitably fall short of international investors' expectations, and should be seen only as a stopgap measure that sets the stage for full legal and regulatory reform.

8. Board evaluation and succession

46. The Code should encourage greater board effectiveness by requiring regular board evaluation, through both annual self-evaluation and periodic independent assessments, along with annual disclosure to shareholders on findings, actions points and progress.

47. The Code should also require the nominations committee to disclose its processes surrounding executive and board succession planning and recruitment.

Box 11. Comments to the Code

We welcome the provision in Section 2.1.2.9 recommending that boards undertake annual evaluation of their effectiveness, and specifying that such reviews be carried out by an external, independent party at least once every three years, with the option of self-assessment in other years. We also welcome the recommendation that the key results of such assessments be reported annually to investors, together with the publication of the comfort letter from the independent consultant. These constitute important positive steps that are consistent with global best practice.

We also welcome the recommended disclosure of the number, type (i.e. in-person/telephone) and attendance levels of board meetings (Section 2.1.4.3), as this can help inform investors evaluate individual board member effectiveness at director re-elections.

On the other hand, we note with some concern the minimal attention accorded to the nominations committee's responsibility to lead succession planning, both of the board and of key executives (Section 2.1.4.4.3.). Equally, despite positively referencing board induction, the Code omits any reference to on-going board training and development.

TRANSPARENCY

48. A dominant concern of international investors relates to the need to minimise the asymmetry of information that exists between minority shareholders and controlling shareholders. A key objective, therefore, of the revised Code, should be to establish an overall disclosure policy that is both fair to all shareholders and continuous for all material developments.

1. Disclosure of beneficial ownership

49. Boards should commit to make full and comprehensive disclosure of all beneficial owners with substantial stakes (for example more than 5%) and affiliated parties, including all material information regarding share ownership and voting rights.

50. In this context, it is imperative that the definition of who is a related party, a controlling shareholder, an affiliated party and a shadow related party be clarified and strengthened.

51. We note and welcome the support expressed by President Putin for such disclosure in the context of his promotion of 'de-offshorisation'.

52. Boards should commit to disclose all material Related-Party Transactions ("RPTs") and submit them for the review and sole approval of INEDs.

53. To aid transparency and permit effective scrutiny by the INEDs, identification and disclosure of RPTs must be made based on IFRS, not only for parent companies as is required under pending Russian law, but also and importantly for all subsidiary operations and affiliates, which remain exempt from the IFRS reporting requirement (see IFRS reporting below).

54. Boards should commit to place all material RPTs to an *ex ante* vote by shareholders who are not conflicted only. Shareholders, key board members and executives with a material interest in transactions or related matters must fully disclose such involvement and must not vote.

55. NOTE: These recommendations rest crucially on the appointment of properly competent and independent INEDs, as called for above. We note and welcome proposed provisions regarding RPTs in the *Novy Rynok*, but caution against the limited role defined for INEDs in the *Novy Rynok*'s proposed standard.

Box 12. Comments to the Code

We welcome the recommendations in Section 6.4. specifically urging companies to disclose "all material information, even if not required by law", and in particular the stipulation that this be "not only about itself but also about any legal entities which are controlled by and are material to the company".

We positively note the Code's call for information on RPTs based on IFRS, the latter's materiality threshold of 1% (versus the 2% set by Russian law), and the greater detail that the Code recommends with respect to RPT disclosure. IFRS reporting is a welcome improvement, but its limitations must also be borne in mind.

Finally, we commend the Code for its explicit call for "information about possible or actual acquisition by certain shareholders of a degree of control disproportionate to their shareholdings in the share capital of the company, including on the basis of shareholder agreement or the existence of ordinary and preferred shares with different nominal values".

Provided it is genuinely complied with, i.e. in substance rather than merely in form, such a disclosure standard will be positively viewed by investors and help to alleviate concerns about poor transparency. In combination with effective oversight by properly independent and competent audit committees, such transparency can help build trust and protect the value of investments.

2. Timely and consistent disclosure

56. We urge that RAS and IFRS accounts be disclosed simultaneously.

57. We note that investor information is often provided mostly in Russian, and urge the Code to require that all information be released simultaneously in both Russian and English any company where there is a significant international investor base.

58. We note the tendency for the quality and timeliness of investor information to deteriorate following the initial levels established at the time of IPO. We therefore urge issuers to maintain a sustained level of disclosure, consistent with that established at the time of the IPO, as well as professional standards of investor relations.

Box 13. Comments to the Code

We welcome the provision in Section 6.1. recommending simultaneous domestic and international disclosure of material information for companies whose securities are traded on foreign markets, as well as the call for electronic means of communication.

However, we regret the omission of any reference to English-language disclosure, and caution that this risks undermining Moscow's ambitions to become and International Financial Centre by 2020. We also encourage the Code to articulate a set of good practice guidelines for Investor Relations activities against which companies can be benchmarked.

We welcome the Code's explicit recognition of the board's responsibility to treat all shareholders fairly "in cases where (its) decisions (…) may have different effects on different groups of shareholders" (Section 2.1.1.). Yet despite this, we note with concern that it is silent on the particular challenges facing DR holders, as well as the disproportionate access to information afforded to holders of 25% of shares, both of which should be remediated and treatment equalised.

In light of concerns that controlling shareholders may have undue influence and privileged access to information, we welcome Section 2.1.4.2's further emphasis on the need for all board members (emphasis added) to have "equal rights of access to documents of the company and those of the legal entities controlled by the latter"; and that the sharing of confidential data on an unrestricted basis likewise requires board members to reciprocate with proper protection of confidentiality.

59. The Code should consider issuing a set of standardised best-practice Investor Relations guidelines against which companies could be benchmarked.

3. IFRS financials

60. In light of the current concerns arising from the dual system of accounting, we welcome the requirement that all consolidated accounts be issued according to IFRS.

61. We would also encourage companies to adopt IFRS for interim (semi-annual, quarterly) accounts.

62. Most significantly, we note the exemption that still applies to non-consolidated subsidiary operations, and would therefore urge companies voluntarily to adopt IFRS reporting across all reporting entities.

- Insofar as RAS are currently required for such individual entities, they form the basis for determining net income for purposes of determining tax liabilities and dividend distributions. Any discrepancies between tax and financial accounts, and between RAS and IFRS, should be fully explained, so that rather than reducing financial results to match tax figures in order to deflect the risk of spurious tax audits, reported financial results can be reported in their full amount and thereby support appropriate levels of dividend payout.

- While we urge the Code to require companies voluntarily to resolve these discrepancies through the above-noted comprehensive reporting, we believe the best outcome lies in the introduction of a clear timeline by the regulatory authorities to abandon RAS as soon as possible and establish IFRS as the sole reporting standard[5].

63. We note that the use of IFRS is only as effective as the standard-setting and enforcement structures in place to monitor its implementation; further, we note that special exemptions (e.g. on disclosure of ties between managers and suppliers/contractors for SOEs with over 25% state ownership) undermine the overall effectiveness of this standard, and by implication the credibility of broader reform efforts. We therefore urge the Code to emphasise the need for consistent application of the standard, particularly as regards RPTs.

Box 14. Comments to the Code

We note that the Code is silent on the need for IFRS reporting to be extended to non-consolidated affiliated companies, and strongly recommend that it urge companies voluntarily to address this gap, particularly insofar as opacity related to the discrepancy between RAS and IFRS can result in depressed dividend payments.

4. Remuneration

64. We note the significant gap between emerging global best practice and Russian practice with regard to shareholder oversight over executive pay. In particular, investor attention in other markets has shifted below board-level compensation to the executive, and focused on the extent to which incentives are aligned with risk and long-term value creation.

65. We encourage companies to improve transparency on remuneration of board directors and key executives, by disclosing on an individual basis: base salary, variable cash and non-cash awards, all cash and in-kind benefits, severance arrangements, golden hellos and parachutes, and performance targets calibrated to an appropriately-selected and disclosed peer group.

66. We note that under Russian law, the board lacks the power to oversee executive pay policies. However, global experience has shown that pay transparency without accountability to

shareholders has contributed to a rapid escalation in pay levels that has been unsupported by underlying corporate financial performance. Global best practice therefore requires boards to be accountable to shareholders for the adoption of appropriate executive pay policies; this accountability may take the form of periodic (annual to tri-annual) shareholder votes on both remuneration policy and actual pay packages or annual votes to renew board remuneration committee members. We encourage the Code to keep the introduction of appropriate accountability mechanisms under review, e.g. by setting a periodic "Say on Pay" requirement as a best-practice standard in the Exchange's highest-level premium *(Novy Rynok)* segment, together with publication of vote results.

67. Transparency and accountability on remuneration should apply equally to private sector companies and SOEs.

Box 15. Comments to the Code

We welcome the Code's recommendation that a majority-independent remuneration committee lead the development of remuneration policy, and that this policy "comply with the principles of transparency and accountability" (Section 2.1.2.5). However, the Code omits guidance on how this accountability is to be delivered, given the absence of any practical shareholder oversight mechanism, e.g. via a vote.

It is positive that the Code recommends a prohibition against board members hedging their shareholdings in the company (Section 4.2.4). It should ban any pledging of material shareholdings by board members and senior executives, or at a minimum require full disclosure.

The Code also sets a remarkably good standard in relation to the need for comprehensive disclosure of pay policies for executives and key employees (i.e. salary, cash and non-cash benefits); short- and long-term incentive plans with lock-ups and performance conditions (4.3.3.); clear KPIs tied to long-term value generation; use of peer groups with careful targeting to avoid "spiral increases"; non-financial targets; and even clawback provisions in the event of unlawful payment of funds.

It is also commendable that the Code explicitly addresses the need for alignment between pay, risk management and long-term value creation (Section 4.3.6) .

The Code urges individual disclosure of pay at board level, but stops short of calling for individual or even banded pay disclosure of highest-paid executives. Although this lags global best practice, it is our understanding that the real priority concerns self-dealing arising from related-party transactions, rather than outsized executive remuneration. Should self-dealing be successfully brought under control, and give rise to pay concerns similar to those experienced in other markets, we would advise that a future revision of the Code consider individual disclosure of top executive remuneration, as well as the introduction of a Say-on-Pay provision.

CREDIBLE MINORITY INVESTOR PROTECTIONS

1. Equal rights for all shareholders

68. The provision that currently allows shareholders who hold over 25% of shares to have unlimited access to information should be eliminated.

69. Minority investors must have access to full information about subsidiaries and related parties, and enjoy equal treatment on payment of dividends, e.g. within any series of a class, all shares should carry the same rights.

70. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase them.

71. Insofar as so much exposure of international investors is via Depository Receipts (DRs), we urge that the Code ensure that DR holders enjoy the full range of equal rights compared with ordinary shareholders, including with regard to voting, board nomination, dividends and pre-emption[6].

2. Additional protections in cases of controlled companies

72. At the heart of international investor concerns lies the high incidence of controlled company ownership structures – not because this *per se* undermines investibility, but because it is frequently associated with inequitable treatment of minorities by dominant shareholders. We therefore urge the Code to require controlled companies to adopt the following additional protections as a means of safeguarding minority shareholder interests and rights:

- INED-only votes on RPTs: Explicit requirement that only independent directors may vote on RPTs;
- Free float: A minimum free-float requirement of 30% for issuers admitted to the premium *Novy Rynok* segment;
- Aggregation of RPTs: Disclosure of RPTs to aggregate transactions conducted over a 36-month time frame; and
- INED veto: INEDs should have a right of veto on substantial corporate actions affecting the rights and interest of minorities.

3. Mandatory tender offers

73. We regret the absence in the Joint Stock Company law of amendments to the takeover regulation, in particular the introduction of mandatory tender offers and squeeze-outs. Such measures form the basis of vital investor protections, and in their absence, the Code should urge companies voluntarily to fill this gap.

74. In particular, major shareholders must make a full offer on transparent terms based on market prices when their ownership stake successively reaches 30%, 50% and 75% of voting shares in open joint stock companies. This is in line with the proposed provision in the *Novy Rynok*, but should serve as a basic minimum standard that applies to all companies rather than just those listed in the premium segment.

75. The Code should ensure that all significant shareholders make a public commitment guarantying tag-along rights for minority investors in the event of any transactions in which they make a takeover bid. The Code should therefore urge companies to commit to the following when confronted with a takeover:

- When seeking to acquire another company, the acquiring company should commit to making a full offer on equal terms to all shareholders;
- When a company is the target of an acquisition, the board of the target company should ensure that its controlling shareholder(s) commit(s) not to agree the sale of its (their) shares unless the acquiring company makes a full bid on equal terms to all shareholders.
- Boards should take an active role in relation to any takeover process, including:
    - Closely monitoring takeovers;
    - Seeking to prevent any transaction made without a mandatory tender offer: this includes indirect takeovers made through the acquisition of a related controlled entity rather than through the direct acquisition of shares;
    - Monitoring and challenging any reasons given as a basis for refusing to make a tender offer or for a squeeze-out;

- Assessing the price of a tender offer;
- Disclosing their opinion regarding the takeover and related issues.

- Boards should, to the greatest possible extent, seek to persuade the acquiring shareholder to disclose its real takeover price, including its non-cash components, and share information on all entities and individuals involved in the acquisition in order to:
  - Secure a fair price for the tender offer;
  - Exclude possible avoidance of the requirements to make tender offer; and
  - Rule out the possibility of effecting a squeeze-out that complies in form but not in spirit with the law.
- We also urge that the Code explicitly disallow squeeze-outs that formally comply with the law but are in fact structured to circumvent its requirements, as well as any other actions by companies to give the appearance of compliance with the mandatory bid provision while avoiding its intended impact by actively delaying the effective date of the bid so as to manipulate the actual bid price (defined as weighted-average of the prior six months' share price). We note that the FFMS has prepared a draft law to address these concerns, and that the Supreme Arbitrazh Court also has draft Memorandum, and look forward to these efforts providing additional traction for the Code's objectives in this area.

76. We welcome the *Novy Rynok* provision calling for a mandatory bid by major shareholders upon delisting from the premium segment. We urge that the Code make this a *de facto* standard across the whole of the market, irrespective of listing segment.

77. Companies must prevent any attempts by controlling shareholders to receive profits from the company other than through dividends, including by way of transfer pricing and asset-stripping.

Box 16. Comments to the Code

We note the Code's call (Section VII.) for shareholders to be able to influence major corporate actions and enjoy an adequate level of protection, including by requiring INEDs to take an active part in negotiating major transactions and make themselves available to investors. We welcome its explicit call for companies to be "guided by the principles of the Code" rather than merely "comply with the formal requirements of the law"; and to take additional measures to fill gaps in the law, focusing in particular on material transactions involving controlled companies.

We welcome the Code's insistence that the board take a lead role by assessing whether transaction values are just and fair to small shareholders – in particular its calls for the board to:

charge a special committee including INEDs to resist improper pressure from controlling shareholders or related entities; block transactions it deems contrary to the interests of all shareholders; disclose dissenting board member opinions; press for a voluntary or mandatory offer and evaluate terms and conditions; prevent attempts at share price manipulation aimed at lowering the takeover price; and retain an credible independent appraiser and publish its report. All of these measures seek to meet the concerns we outline in our recommendations. We also welcome the call for shareholders to be entitled to redemption of their shares, again backed by independent appraisal.

We likewise note the Code's insistence that these good practice provisions apply equally in cases where a third party is acting for the company, as well as its call for transparency regarding the range and nature of these shadow related parties; and we especially welcome the Code's insistence that such de facto related parties be prevented from voting – a frequent problem involving the deliberate misuse of Treasury shares, which we urge the Code to prohibit.

We note that the Code includes a general provision requiring that "minority shareholders be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly". In light of the challenges inherent in legislating for all possible circumventions of this principle, and in line with the Code's call for substance over form, we urge that the Code prohibit companies from, among other things:

* Using loopholes that allow bidders lawfully to avoid launching a mandatory tender offer, e.g. by purchasing DRs (which technically do not count towards the legal threshold that triggers a mandatory bid);

* Acquiring control of another company that in turn owns shares in the target company, with agreements to act in concert in a manner that escapes the currently insufficiently comprehensive definition of affiliated parties;

* Reducing shareholdings below the statutory thresholds (30/50/75%) by distributing excess shares to parties that escape the affiliated parties definition, yet are de facto subordinate;

* Deliberately misusing anti-monopoly laws and other regulations requiring state approval, by omitting to seek prior consent under these laws, thereby invalidating mandatory bids while continuing to accumulate shares.

Finally, we welcome provisions related to delisting of shares that require transparency, urge the acquirer to make a voluntary offer on fair terms, and prevent a forced delisting.

Overall, the Code sets out a substantial number of recommendations that seek to allay serious and longstanding investor concerns. This is welcome. The key to this is evidence of traction on the ground: provided these measures are shown to deliver visible change in practice, they are a positive step towards rebuilding investor confidence, and in turn, boosting valuations.

We note (section 7.1) the Code's recommendation that even though not required by law, boards retain an independent appraiser to determine the market value of an asset in the event of a material transaction or RPT – and further, that they "provide a good explanation" if they opt not to do so.

Finally, we welcome the Code's recommendation that board members abstain from voting on matters in which they have a conflict; and otherwise refrain from actions that will result in a conflict (including gifts to themselves and family).

The Code contains exhaustive language detailing a series of obligations by the company and its board to safeguard minority investor rights in relation to potential conflicts arising related-party relationships. Although positive, the real impact of this will depend on how results on the ground – evidence of which will be clear to investors in the selection of truly independent and trusted board members, the availability of management and the board for investor dialogue, and the behaviour of controlled companies in the event of RPTs that require strong and transparent oversight.

4. Voting of shares held by parties under issuers' control

78. In the absence of any prohibition of such practice, companies should voluntarily commit not to vote treasury shares held by controlled undertakings, including by refraining from handing control of treasury shares to friendly parties.

79. We welcome the proposed *Novy Rynok* provision to this effect, but urge that the Code apply this standard to all companies irrespective of listing segment.

5. Pre-emption

80. We note and welcome the proposed *Novy Rynok* provision requiring extension of pre-emption rights to other share classes.

81. We encourage the Code to include specific voluntary best-practice commitments on the part of block holders and controlling shareholders, articulating a clear duty to fellow shareholders.

Box 17. Comments to the Code

We welcome the Code's candour in acknowledging the extent to which legal protections regarding pre-emption fail to deliver in practice, particularly its reference to the use transactions that include illiquid non-monetary assets deliberately to manipulate valuations. We welcome its explicit discouragement of such tactics, and its call for INEDs to have an effective veto right.

We also welcome its active discouragement of multiple share structures, its support for one share-one vote, and its demand that new placements not violate dividend rights or cause dilution.

As with other aspects of this Code, the remedies it calls for rely on companies exercising discretion to protect investors, and therefore their impact on investor confidence will depend on evidence of widespread adoption.

EFFECTIVE REDRESS

82. Although not specifically within the purview of the Code, we note the grave concerns foreign investors have regarding the difficulty in obtaining fair redress in the event of commercial dispute. While the solution lies ultimately in judicial reform, we urge the Code to require companies to commit to binding arbitration as a means of resolving disputes[7].

REPORTING AGAINST THE CODE

83. Given its purely voluntary status, we recommend full disclosure against the Code on a Comply or Explain basis, and that there be clear obligation for companies to report not only on gaps in compliance, but where applicable, on plans for compliance over time.

84. We also note that the Comply or Explain approach has shown serious limitations in the case of controlled companies. We therefore emphasise the critical importance of the additional protections outlined in section 3)c (Credible Minority Protections) above, including the implementation of effective oversight mechanisms.

85. In addition, we urge that the core investor protection provisions contained in the Code become the subject of regulatory compliance and credible enforcement. Such evolution should be initiated with the passage of this Code, with a clear timetable for adoption of specific key provisions.

SUMMARY AND CONCLUDING OBSERVATIONS

86. A pathway for ambitious change:

- We note that fewer than 20% of listed issuers fully meet the requirements of the 2002 Code, with no explicit reporting obligation, no oversight and very limited powers for the Exchange to verify self-reported information.

- That being the case, we recognise that seen in the context of a strengthening of the 2002 Code, the above recommendations set an ambitious standard, both for companies and for the Exchange and regulatory authorities.

- Nevertheless, we see it as critical for Russian listed companies in the private and SOE sector to lift governance standards, failing which we see little prospect of international investors favouring this market over alternative, more attractive opportunities.

- We are convinced that clear progress as outlined above, backed by credible evidence of change on the ground both by companies and by regulatory authorities, has the potential to mitigate the challenges inherent in Russia's heavily state-dominated economy and, with time and consistent reform, can play a major role in attracting investment from international investors.

87. Practical steps forward:

- Although comprehensive, as written the code is not structured in a manner that is very "user-friendly", with inter-dependent recommendations split across disparate sections.

- To ease adoption, benchmarking and performance reporting, we recommend issuing a concise list of key recommendations, numbering each item so as to enable both companies and investors to monitor progress

- This will also facilitate review by proxy voting agencies who need to evaluate ballot proposals and can assess disclosure against specific relevant Code provisions.

APPENDIX: LIST OF SIGNATORY INSTITUTIONS

Aberdeen Asset Management

Första AP-fonden/First Swedish National Pension Fund (AP1)*

Andra AP-fonden/Second Swedish National Pension Fund (AP2)

Tredje AP-fonden/Third Swedish National Pension Fund (AP3)*

Fjärde AP-fonden/Fourth Swedish National Pension Fund (AP4)

APG All Pension Group

Bâtirente*

British Columbia Investment Management Corporation

Cartica Capital

Church of England Pensions Board*

Church Commissioners for England

Co-operative Asset Management

CtW Investment Group

Etica Sgr

F&C Asset Management

Florida State Board of Administration

Fonds de Réserve pour les Retraites*

Hermes Equity Ownership Services Ltd

Hexavest Inc.*

ING Investment Management

KLP Kapitalforvaltning AS

Legal & General Investment Management

MN Services N.V.

Natixis*

PGGM

Railpen Investments

Sarasin & Partners LLP*

Standard Life Investments*

Swedbank Robur Fonder AB*

T. Rowe Price International

UAW Retirement Medical Benefits Trust*

USS Investment Management Ltd

Trade Associations also consulted but not actively participating in drafting: SHARE and Eumedion.

NOTES

[1] We also welcome the President's commitment to introduce a number of positive reforms to laws and regulations, and several advances made to date in corporate practice, including among others: the requirement for IFRS reporting; the regulation of delisting; the passage of insider trading legislation; reforms by the Moscow Exchange enabling trade settlement at T+2 from T+0; practical progress realised in the banking sector, including early adoption of IFRS and improved disclosure of beneficial ownership; and specific measures taken in the context of President Putin's 'de-offshorisation' efforts.

[2] Crédit Suisse

[3] This progress is echoed in worldwide efforts by fellow stock exchanges to drive improved standards by issuers, including those undertaken under the aegis of the Sustainable Stock Exchange initiative.

[4] Moscow Exchange, 2012.

[5] We note several signatories to this submission have voiced reservations regarding the IFRS, noting that the convergence between US GAAP and IASB has led to an over-emphasis on "neutral accounting", thereby undermining the principle of prudence and the provision of a "true and fair view" of a company's financial position. The investors are working to ensure the on-going review of the IFRS Conceptual Framework takes on board these considerations , calling for specific actions to address these concerns (see http://www.uss.co.uk/Documents/Concerns%20with%20IFRS%20in%20the%20EU%20-%20a%20long%20term%20shareholder%20position%20paper%2023%20Nov%202012.pdf). Notwithstanding these reservations, the signatories of this submission regard the introduction of IFRS in Russia as a critical improvement in the local context and broadly support their application.

[6] In light of on-going reforms surrounding the status, and therefore obligations of, depository banks, some of which may work against their ability to facilitate pre-emption for DR holders, we urge that the Code and relevant regulatory bodies ensure that such equal status prevails.

[7] We welcome the proposed Novy Rynok provision regarding company reliance on such binding arbitration, and emphasise the value and urgency of such a measure, not just in the Novy Rynok but across all listing segments. We therefore urge that the Code require that all companies commit to this as process for dispute resolution. We note also the tendency of companies to turn to foreign courts rather than state courts, which is unsustainable and vulnerable to interference from the Russian judicial authorities if they reject their legitimacy and invalidate judicial outcomes. However, we also note also that minority shareholders cannot rely on the board to help resolve disputes fairly because of the influence of controlling shareholders. Therefore, we see the use of arbitration mechanisms as a helpful, but only stopgap, measure that ultimately can only achieve its desired intent with further fundamental regulatory, judicial and cultural reform. This should include the successful conclusion of international accords enabling cooperation with foreign regulatory authorities and sharing of information (see General Comments above), as well as clear separation between regulatory, political and judicial functions.