Implementation of Corporate Governance Code in Russia

Alex Williams
INED PAO Enel Russia, PAO DIXY and PAO KTK
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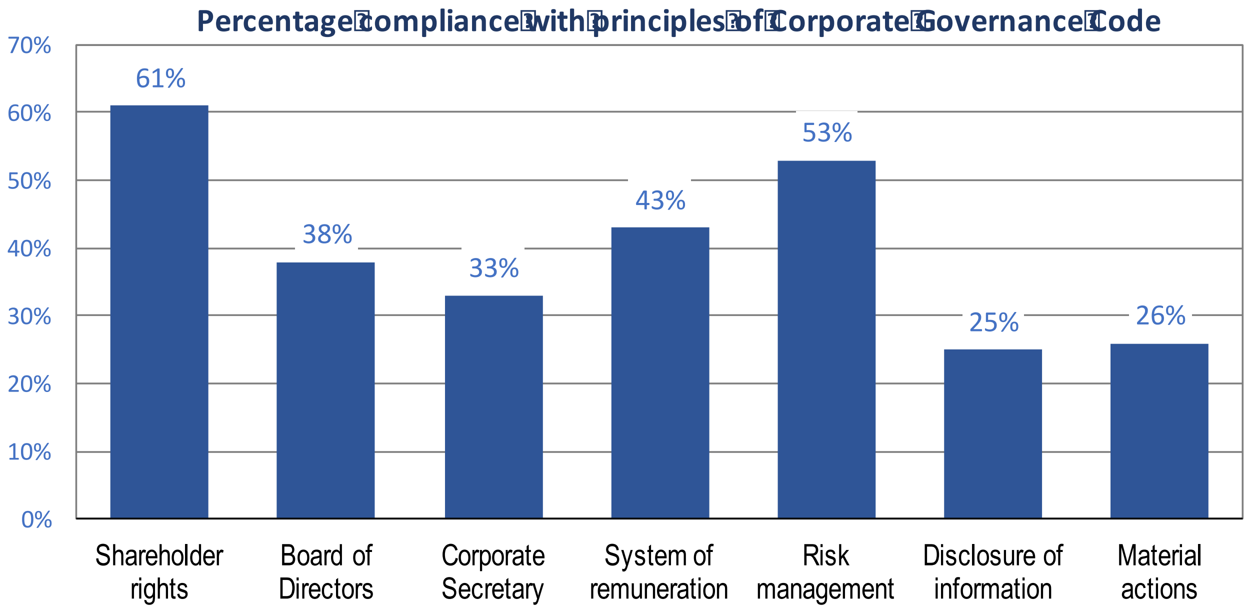
Percentage compliance with Code



Source: Elena Kuritsyna, Director of Financial Market Access Department, Bank of Russia. OECD Russia roundtable, 2016.

- If the Corporate Governance Code is so good, then why is the level of implementation relatively low and what is the direction of travel?

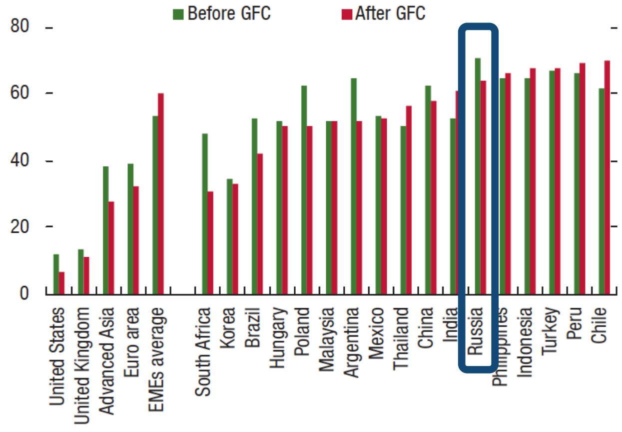
Contents

- Roles of various participants in implementing the Corporate Governance Code;
  1. The role of the majority owner
  2. The role of the board
  3. The role of management
  4. The role of institutional investors
  5. The role of regulators
- Feedback for policy makers

Ownership concentration in Russia

- Around 70% of shares in Russian companies are closely held, meaning that the principle source of friction is majority/minority
- In Western markets: the agency problem is the more common source of problems.

2. Closely Held Shares
(Percent of outstanding shares; market value weighted averages)



Sources: Organisation for Economic Co-operation and Development, Corporate Governance Factbook (2015; panel 1); Thomson Reuters Datastream (panel 2); and IMF staff calculations.
Note: Shares of market capitalization of country groups with different ownership structures are shown in panel 1. Economies included in the dispersed ownership category are Australia, the United Kingdom, and the United States. Economies included in the mixed ownership category are Canada, Germany, Japan, the Netherlands, and Switzerland. Other economies included in the concentrated ownership category are selected major emerging market economies. Closely held shares = shares held by insiders (for example, officers, directors and their immediate families, individuals with more than 5 percent of the outstanding shares) or held by other companies, except those held in a fiduciary capacity; EMEs = emerging market economies; GFC = global financial crisis.

Source: IMF Financial Stability Report, October 2016, Chapter 3. Corporate Governance, Investor Protection, and financial stability in emerging markets.

1. The role of the majority shareholder

- Russia is slightly unusual in that the majority of listed companies have a single dominant shareholder.
- Accordingly, the views of one or two individuals at the majority owner will generally drive the attitude towards corporate governance.

Governance view of minorities (partially shared by Exchange and Regulator)	Governance view of some majorities
• Leads to trust in public markets. • Safeguards property rights. • De-risks companies via better decision making.	• It's a challenge to management and weakens decision making capacity. • Generates a lot of paperwork with little useful benefit. • Frustrates efforts to be paid for services from the majority owner.

- The above views are incompatible, being on the board implies that non majority directors should be prepared to debate vigorously with majority.

1. Basic realities for majority owners

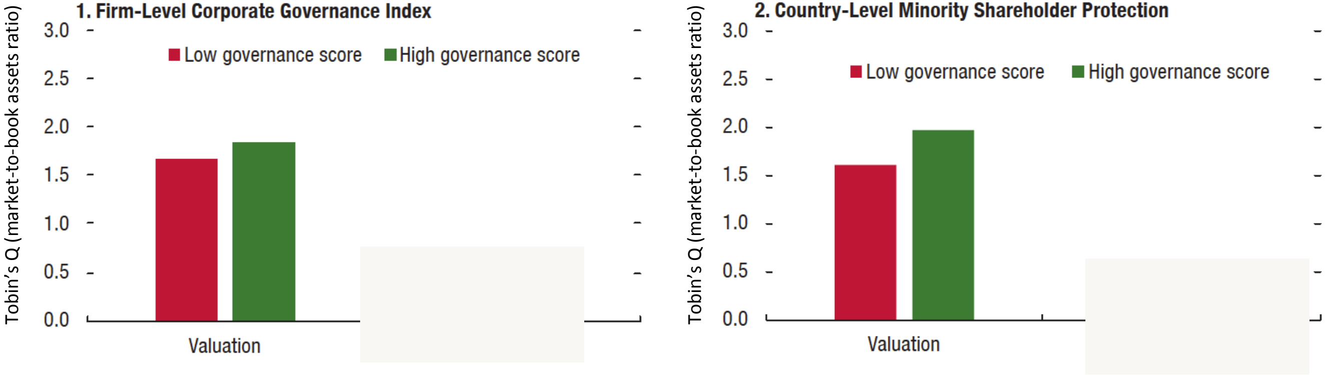
- Many majority owners have bought into the benefits of good governance, including:
  - Correlation between good governance and higher valuations;
  - Lower risk and better decision making from board diversity.
- For those majorities that don't buy into these ideas, they should be aware of:
  - Lower share price if governance practices fall short of expectations of institutional investors.
- Convincing majority shareholders and company management of these basic realities can be a painful process.

1. The benefits of good governance

- There are numerous studies quantifying the effects of good corporate governance, a recent IMF paper provides compelling evidence that good governance boosts valuations at the firm level and that better minority shareholder protection boosts valuations at the country level.

Figure 3.7. Corporate Governance and Firm-Level Valuation
(Ratio; average)

Firms with stronger corporate governance frameworks tend to have higher valuations.



Source: IMF Financial Stability Report, October 2016, Chapter 3. Corporate Governance, Investor Protection, and financial stability in emerging markets.

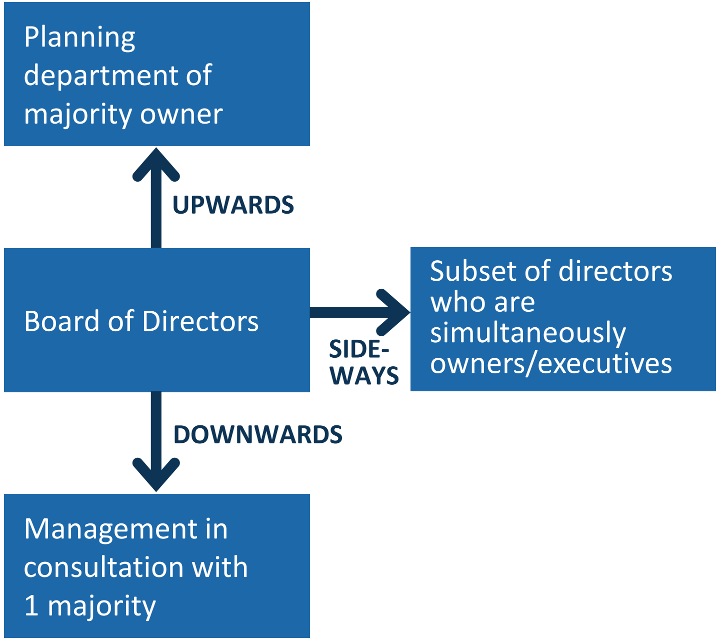
1. Majority objectives overriding market capitalisation

- It would appear that maximising long term shareholder value in a socially responsible way is a non-controversial objective, however there are several circumstances in which shareholder value considerations are sub-ordinated to other objectives, for example;

Group level objectives	The objectives of the majority owner (often a liquidity requirement) create considerations which conflict with objectives of a stand alone listed entity.
“Management fees” paid to majority	Majority shareholder decides that they are entitled to a revenue stream over and above dividends.
Policy objectives	State Owned Enterprises can pursue government policy objectives.
Public market fatigue	After a period of time, private to public owner/managers lose patience with governance requirements.

- In all of the above cases the actions of majority are opposed to interests of minorities (and other stakeholders) and this **will** lead to conflict at the board.

1. Majority diverts decision marking



- Russian corporate law and the Governance Code, gives Boards extensive powers to perform their duty as shareholder representatives.
- However in practice real decision making can drift up, down or sideways. It can be a major challenge for an INED to ensure the board performs the function for which it was designed.
- Failure to do this means that board is just window dressing and committee regulations etc. are meaningless.

2. The role of the board – real voting

- Below is a stylised voting history;

Issue	Governance Code	Impact on decision making by directors	Votes against
Management fees over 3 year period	1.2.4	Ignored	3
Appointing deputy CEO as Chairman	2.5	Ignored	1
Appointment dependent secretary	3.1	Ignored	1
Approval of CEO incentive scheme without any reference to company share price	4.3.2	Ignored	1
Exempting related party transactions from tender requirements	1.2.4	Ignored	1

- In these disguised examples, the board showed a disregard for the Corporate Governance Code, which has been so painstakingly put together by OECD, BoR, MOEX and other market participants.
- It would be useful to ensure that plc. board members certify that they have read the Code and there are ways to identify directors who regularly fail to follow the Code's recommendations.

2. The role of the board

- Why are some directors who are not employed by majority shareholder voting against the Code?
- Possible explanations;
  1. Failure to understand that bad governance is a zero sum game and bad governance needs to be opposed, its not a win-win negotiation.
  2. Don’t have time to invest in checking management analysis.
  3. Unwillingness to challenge Groupthink.
  4. High possible legal costs if sued by majority.
  5. Dependence on majority shareholder for nomination.
- Bottom line: a majority dominated board + one or two independents will do what the majority shareholder wants, not what the Code says.

3. The role of executive management

- Executive management are often associated with a majority owner and in such cases career progression with the majority owner can be more important than fiduciary responsibilities towards a diverse group of shareholders.
- Executive management represent a key governance problem even with an independent board and much more should be done to pursue executives breaching their fiduciary duties, particular problems relate to;
  - Unreliable and biased “analysis” to support majority decisions;
  - Refusal to provide information citing work required to generate information (which exists anyway);
  - Delaying improvements to governance again relying on unreliable analysis.
- Legislation recognises that there should be hurdles to related party transactions, but there is no hurdle to appointing executive management who are employed by (or otherwise affiliated) with majority shareholder.

4. The role of institutional investors (II) in Russia

- For Russia dedicated fund managers there are not many that are activists – although activists generally receive bad press they are absolutely critical to governance ecosystem.
- As an INED would suggest to II:
  - Fully use nomination rights which allow shareholders owning 2% to nominate candidates to the board (API can help with this process, api-russia.org).
  - II pay much more attention to board fees, since lowering board fees (to zero) is a tool to maintain bad governance and little attention is paid to this.
  - Offer some support (guarantee) in event that INED entering into contentious governance dispute.

Summary of governance flow chart

Body	Impact of Corporate Governance Code
Majority shareholder decides on unusual related party transaction	Don’t care
Board staffed with majority nominees plus one or two independents nominated by majority	Possibly tweak a few terms in the related party transaction but no meaningful opposition
Executive management (affiliated with majority)	Will implement Board decision
Minority shareholders	Shareholders with stewardship groups will deal with mega-caps, that leaves one or two activists who then need to invest a lot of time and money to challenge bad governance
Regulator	Last line of defense, hope that CBR roles out some of the Board and Management suitability and liability criteria in the Banking Law to the corporate sector

5. Sanctions for bad governance

- Bad governance can generate specific short term benefits (access to cash) whilst drawbacks can be vague and distant (relative under-performance of equity).
- Western practice centers on engagement, however that is likely to be relevant for very large fund managers who can afford a governance team and corresponding mega-caps. Engagement will be limited at mid cap level.
- Directors personal liability shown inTGK-2 decision is an important tool but it would be good to extend this to executive management.
- For the Exchange and Regulators it is difficult to fine a company as the victim (minorities) are punished alongside the perpetrators, it would be good to see much bigger fines (rather than listing downgrade) and focused on;
  - Executive management; and
  - Majority shareholder (Civil Code establishes a Parent Co.'s liability).
- The CBR approach of taking significant action against rogue directors/management in the banking sector could be extended to corporate sector.

Some observations relevant to CBR/MOEX

1. It is unrealistic to expect independent directors who are nominated by majority shareholders to be truly independent.
2. Directors should sign some kind of undertaking that they have read the Code, understand their legal responsibilities and there should be a way for CBR to identify directors who regularly vote against recommendations in the Code.
3. There needs to be a wider group of people excluded from related party transaction approval, not just executives of related party but all employees of majority shareholder who are simultaneously board directors.
4. Board voting should be disclosed properly, disclosure of items such as “other business” etc. should not be allowed and disclosure of voting should be mandatory with voting by independents identified separately.
5. CEO involvement in committee’s appointment of external advisors can be (and has been) used to de facto block such access to advice.

Conclusions

- Corporate Governance is part of a much wider social debate on morality and ensuring the interests of the few don't override the interests of the many. Each country therefore has a different balance between voluntary codes and regulation.
- In this respect, the Western "light touch" approach appears weak, many of the **individuals** involved in bad governance are not going to be influenced by a Code. The CBR approach as set out in the Banking Law focuses on weeding out unsuitable directors and managers which makes a lot more sense than imposing tonnes of legislation on all companies to force good behaviour. Although banking is a special case, it would be good to see some of these concepts rolled out to the wider corporate sector.
- There need to credible punishments applicable to individuals (directors and executives) who regularly abuse minority shareholder rights and act in way that is detrimental to minority shareholder and other stakeholders.

Taiga Capital Limited
Company number 8596961
Bay Lodge
36, Harefield Road
Uxbridge
Middlesex

awilliams@taiga-am.com
+44 7704 296 332

https://www.linkedin.com/in/aleksandr-williams-75a69011b/