

Evolution of Russian Corporate Governance¹

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Abstract: The Russian corporate governance has evolved since the 1998 financial crisis. The author examines both normalization and preservation in the corporate structure, which can simultaneously be observed in the adaptation of Russian enterprises. The Russian corporate governance reflects the unique interests of its stakeholders and the embedded features of the society, for which the reforms are insufficient from the microeconomic aspects. Since the characteristics of corporate governance in Russia are based on its evolutionary transformation, Russian historical and cultural factors are believed to be retained in the medium term.

Keywords: Russia, Transformation, Corporate governance, Management, Corporate social responsibility, Institutions

JEL Classification Numbers: D23, L22, P23, P31, P50

1. Introduction

According to an assessment of the Russian economy in early 2005 (Ahrend and Tompson, 2005), in contrast to the stable macro-economic management, Russia has retained its weak corporate institutions and business circumstance. Corporate governance is now regarded as the most important institutional requirement.²

In Russia, just as in the case of developed countries, joint-stock companies (hereinafter JSCs) have become the main form of enterprises, with its legal system being constructed after the European and American models. The signs of normalization have become stronger after the revision of the Law on JSCs in 2001. In particular, globalization and the enlargement of the EU appear to have exerted a strong impact on the Russian enterprises. In recent times, we have observed some changes concerning corporate governance. The European Commission has increased its interest in corporate social responsibility (hereinafter CSR) and has published some strategic documents such as the Green Paper in 2001 and Communication from the Commission in 2002. The final paper was published in June 2004. The CSR has also been introduced in Russia, and the EU has a harmonizing³ influence on corporate governance.

However, normalization and harmonization cannot be overemphasized. It has been observed that the rules governing the Russian market are considerably different from those of the West. The law enforcement is not sufficient and corporate behaviour has not necessarily been transformed as much

as the official rules. As can be observed in the case of the Yukos affair in October 2003 (see Mizobata, 2004a), the political influence over corporations is considerably strong and the interests of the stakeholders in decision-making are still complicated. The government's hand has been especially powerful in the strategic sectors. Although normalization and harmonization with the West have often been regarded positively, the behaviour of the large-scale integrated business groups and the volatile investment environment conjure up a corporate image unique to Russia—one that differs from the corporate image of the West.

We can infer that both normalizing and preserving in corporate structure can be simultaneously observed in the transformational recovery and that these dual trends have resulted in Russia diverging from the traditional corporate governance model of the developed countries. This paper uses various empirical data, of which the latest research (Mizobata, 2005) was conducted in August 2004, in co-operation with the Institute for Socio-Economic Problems of Population (hereinafter ISEPN), Academy of Sciences, Russian Federation. This paper analyses the present situation and the changes in corporate governance mechanisms in Russian enterprises. It also considers which stakeholders influence the decision-making of companies. This paper addresses the most classic problem with respect to corporate decision-making, namely, who owns the companies in Russia and whether it is possible to implement corporate governance reform in Russian enterprises.

2. Russian corporations and management principles

2.1. Companies in Russia

Juridical persons (esp. JSCs)⁴ are the central component of Russian enterprise. JSCs are dependent mainly on the Law on JSCs (Mogilevskii, 2004; Makarova, 2003; Dolgopyatova, 2002, pp. 53-56). The formulation of the Law on JSCs was influenced by the legacy of the formation of the Soviet Union, lack of experience and import of foreign experience (Medvedeva and Timofeev, 2003, pp. 85-88). Three types of draft legislations, namely the government draft in September 1991⁵, the deputies' draft in 1995⁶ and Voronez' Oblast legislature draft⁷, were proposed. Finally, in June 1995, the deputies' draft (the American model), which allows a large number of shareholders and has the prospect of expanding the securities markets, was adopted (the first reading). Privatization functioned in the background of the adoption of the Law on JSCs. Since state-owned enterprises were privatized into open JSCs (more than 60,000) and the employees became shareholders in the privatization of Russia, the companies based on a large number of shareholders were chosen as the model. However, many rights pertaining to corporate management were given to the board of directors, and the areas of issues concerning the shareholders' power were limited. In other words, two circumstances affected the law. First, employees and managers received preferential conditions from the distribution of ownership brought about by the privatization. Second, securities markets were immature and the circulation of shares was limited. When a JSC is organized under such

initial conditions, insiders can easily influence not only corporate management but also the corporate legislations.

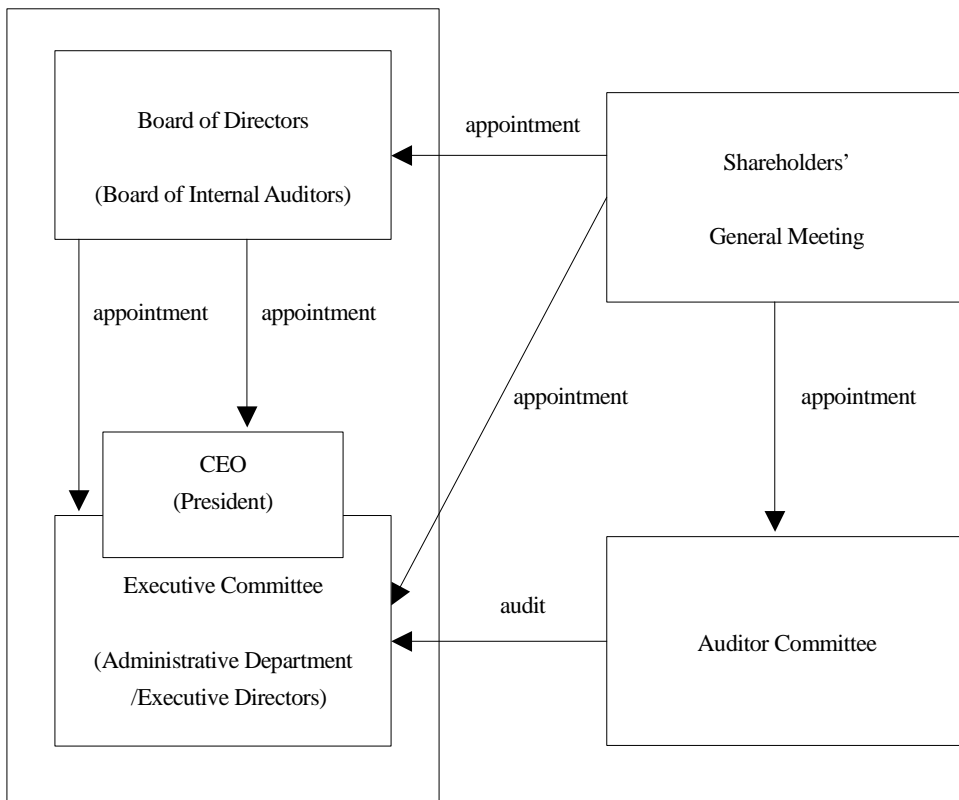
In Russia, the JSCs⁸ can be largely divided into two categories (Molotnikov, 2004): open JSCs, whose premise is the circulation of shares in the securities markets and closed JSCs, whose shareholders are limited to specified members. In the open JSCs, the minimum capital is 1,000 times the official minimum monthly wage, and the number of shareholders is not restricted. Open JSCs have equity and preferred shares (under 25% of capitalization), and reports such as annual financial statements are publicly announced. The minimum capital of closed JSCs is 100 times the official minimum monthly wages. The number of shareholders is less than 50, and shares are not traded publicly. Shares are owned by the specific incorporated companies and individuals, and transfer of their shares to the third party is restricted. It is difficult to 'buy up' control without the consent of the majority of shareholders. Since the shares cannot be resold without the consent of the other shareholders, outsiders who are trying to buy out the shares are faced with a barrier. People's enterprise (closed JSC) based on self-management is a variation of a JSC. In this case, more than 75% of the shares are owned by the employee shareholders, and there is an additional restriction that the number of the company's employees must be greater than 50 and should not exceed 5,000. Corporations that were established in the process of privatization, and the shares of which were owned by insiders can choose this type. However, with the passage of time, enterprises that belong to employees have become more of an exception (Semenov, 2000). People's enterprises were used to maintain inter-business ties and prevent takeovers (Avdasheva, 2000, p. 103).

The Law on JSCs is based on the premise of the open JSC due to the following situations (Medvedeva and Timofeev, 2003, pp. 88-93). First, the open JSC is legally established for the purpose of acquiring investments. However, the purpose of many Russian open JSCs is not to acquire capital for economic reasons, which implies that they are substantially 'semi-open'. In fact, the existence of a large number of closed JSCs and accumulation of capital within the company are the characteristics of the Russian economy. Second, an open JSCs economy can be reorganized into a closed JSC or a limited company. Therefore, an open JSC was regarded as an advantageous form. Further, even open JSCs can avoid free stock transactions. Third, free circulation of shares generates dispersion of ownership, thereby giving rise to efficient owners. The peculiarity of share dispersal in Russia lies in its scale (all departments and corporations) and methods (illegal and uncivilized). As a result, open JSCs have strengthened the concentration of shares. Redistribution of control (capital increase, mergers and reorganization) and bankruptcy procedures (legally, the bankruptcy system does not concern business management, but it can change the structure of companies) are drawing considerable interest as methods for redistributing shares. However, illegal measures were applied, such as the redistribution of control, which does not provide necessary compensation to the shareholders and bankruptcy measures for companies that were capable of paying.

2.2. Management and control structure

The control mechanism of Russian corporations comprises the shareholders’ general meeting, the board of directors, the executive committees and the internal auditors (hereafter, see Mogilevskii, 2004; Zhilinskii, 2002; Doinikov, 2002; Iontsev, 2002; Blyakhman, 1999; Slivko, Kotieva and Borova, 2002; Iwasaki, 2003) (Figure 1).

Figure 1 Main administrative organization of companies in Russia



From the legal viewpoint, the central control mechanism is the shareholders’ general meeting, which reflects the decisions of the shareholders who have voting rights.⁹ The authority inherent in the shareholders’ general meeting includes decisions that may affect the continuance of the company and shareholders’ status such as changes in capitalization, reorganization, liquidation, election of the board of directors and auditors, and capital increase. Although the Law on JSCs regulated the strong authority of the shareholders’ general meeting, it could transfer these exclusive authorities to the board of directors. Therefore, in Russia, investors who owned (or managed) control shares could make all the decisions, and the small shareholders’ rights were often ignored. This implied that there

was a problem with respect to capital increase; it strongly influenced the power of shareholders' rights, which could be decided by the managers; therefore, the shareholders' rights could be easily violated. In 2001, the Law on JSCs was revised and the following regulations were established: 1) At the time of corporate reorganization, when shares were sold in the securities markets due to capital increase, shareholders were given preferential rights for purchasing shares. These rights had to be in proportion to the shares; 2) In case more than 25% additional shares were issued, it was required to be a publicly open offer (not a closed one); 3) It was restricted to change capitalization to limit the authority of preferred stock owners (more than 75% of votes are needed at the shareholders' general meeting); 4) JSCs with more than 50 employees were required to register before the beginning of July 2002. At the very least, these revisions had the potential for avoiding ownership disputes between shareholders and managers due to capital increase and had the function of stabilizing the securities markets and protecting individual investors.

The second control mechanism is the board of directors (the board of internal auditors). The board of directors is elected to guide as a group within a specific period of time and is an organization of enforcement/supervision. In incorporated companies, the authority tends to shift from the shareholders' general meeting to the board of directors. The board of directors manages and directs a company, but in some cases, it turns into a reactionary force against many shareholders.

The authority of the board of directors includes the selection of business priorities, convening of the shareholders' general meeting, capital increase (following decisions by the shareholders' general meeting) and the formation of the executive committee. At the beginning of 2002, the reorganization of the company, capital increase, stock division and integration, approval of large transactions and acquisition of its own shares by the company had to be proposed in the shareholders' general meeting by the board of directors instead of being under the arbitrary authority of the board of directors, as it used to be. The board of directors is elected at the shareholders' general meeting.¹⁰ The number of executive committee members cannot exceed a quarter of the members of the board of directors. By organizing the executive committee, the administrative supervisor (board member) and the management are nominally separated; however, the board of directors is controlled by the head of the executive committee (president) (Kleiner, G., *Nezavisimaya*, 8 May 2001). Conventionally, more than two-thirds of the board members are chosen from the shareholders, and the representative of the directors must be a shareholder.¹¹

A company's operational management is carried out through the executive committee, which is either a collective or a single organ. This organization is responsible for reporting the information to the board of directors as well as at the shareholders' general meeting. In fact, the main management staff of a company organizes the executive committee and prepares a contract with the board of directors. The representative director may not at the same time be the CEO (chief executive officer); however, in reality, these two posts are often held at once, which results in the centralization of authority. The CEO controls the board of directors. The executive committee system is similar to

the 'work meeting', which traditionally formed the basis of Russian enterprises, and its organization is determined by the shareholders' general meeting or the board of directors (Iontsev, 2002, p. 196). Therefore, the authority of ownership, supervision and management can easily be concentrated in a single hand.

The third control system is the labour group (employees). In a people's enterprise, where more than 75% of the shares belong to employee shareholders, the decisions of the shareholders' general meeting and the chief of internal auditors overlap with the decisions of the workers. The authority of the labour group is considerable in unitary enterprises and in companies wherein the state ownership exceeds more than 50% (Zhilinskii, 2002, p. 108). In addition, employees have been able to influence decision-making as shareholders since the employees' holding was given priority in privatization. Although employees (trade union) strongly influence employment and labour conditions, restrictions of employers with respect to the dismissal and flexible redeployment of workers were relaxed in the Labour Code in 2001 (Ashwin and Clarke, 2003, pp. 111-114). Moreover, with respect to employees, while negotiations through social partnership were acknowledged, real influence on management was limited (OECD, 2002, p. 18). The general meeting of the labour group exists only in name; it is not prescribed in corporate laws. It may appear in the form of strikes in a protest situation; however, in reality, there exist only a few cases.

Finally, in Russia, the government can act as a control mechanism over the management through various means such as taxation, legal force, holdings, regulation, subsidies, etc.

3. Ownership and control in the company

3.1. Evolution of ownership and control

The separation of ownership and management in companies has resulted in a controversy in the Corporate Governance Model. Fundamentally, ownership can be regarded as the basis of corporate control. Tables 1 and 2 indicate the evolution of the ownership structure¹² in Russia. While the research results/data of the research organizations differ greatly, similar trends can be observed after 1992.

During the initial period of privatization, an insider had a certain amount of influence in almost all the enterprises. Generally speaking, in the first half of the 1990s, the insiders owned two thirds of the shares, which were mostly owned by the employees. The privatization policy, the underdeveloped securities markets and the legacy of the Soviet Union have had a decisive effect on the change in ownership. At the same time, state ownership remained at approximately 20% and the role of outsiders was restricted. The ownership structure did not undergo evolutionary changes but rather, revolutionary changes as a result of the political decision to privatize (Dolgopyatova, 2002, p. 18).

Table 1 Shareholding structure in Russian joint-stock companies

Shareholders	Result of privatization	1994	1995Q4- 1996Q1
Inside shareholders, including:	66	66	58
- employees	47	44	43
- managers	19	22	12
- collective trust	–	–	3
Outside shareholders, including:	10	16	33
- enterprises, including:			23
- banks	–	–	2
- investment funds	3	5	5
- supplier, buyer, controlled companies	–	–	3
- holding companies, “Financial-Industry-Groups”	–	–	3
- others	–	–	10
- individuals	3	6	8
- foreign shareholders	–	–	2
State	20	12	9
Total	100	100	100

Source: Afanasief, Kuznetsov and Fominuikh (1997)

From 1995 to 1999, there was a fall in the insider ownership whereas the outsider ownership increased. There have been remarkable changes in ownership, such as transfer from state to non-state shareholders and from insiders to outsiders (corporations and individuals). Among insiders, transfer from employees to managers may be observed. Shareholdings, however, are centralized rather than dispersed. Lack of measures for protecting minority shareholders' rights, arbitrary administration of the shareholders' general meeting, directors' arrogance, losses suffered by companies and uncertain information stimulated the centralization of authority into the hands of a few people (Kapelyushnikov, 2000). The ownership change—from insiders to outsiders—can also be observed continuously after 1998. According to an investigation (ownership structure of medium-large incorporated Russian companies) conducted by the Ministry of Economy, the insider ownership declined significantly after 1998, and the outsider ownership increased in 2000, which resulted in an inversion of the status. Among outsiders, apart from individuals, financial and non-financial companies have become the main agents. Although the financial outsiders expanded their ownership, aimed at gaining control over the promising privatized companies, cornered shares

for large-scale inside and outside investors and handled charges and speculative profits, after the 1998 financial crisis, large-scale industrial companies also expanded their ownership.

Table 2 Shareholding structure in the Russian industrial sector

Shareholders	1995	1996	1999	2001	2003
Inside shareholders, including:	54.8	52.1	46.2	48.2	47
- employees	43.6	37.0	31.5	27.2	22
- managers	11.2	15.1	14.7	21.0	25
Outside shareholders, including:	35.2	38.8	42.4	39.7	44
- non-financial outsiders, including:	25.9	28.5	32.0	32.4	36
- individuals	10.9	13.9	18.5	21.1	21
- incorporated companies	15.0	14.6	13.5	11.3	15
- financial outsiders	9.3	10.3	10.4	7.3	8
State	9.1	7.4	7.1	7.9	4
Others	0.9	1.7	4.3	4.2	5
Total	100	100	100	100	100

(%)

Sources: Kapelyushnikov (2001, p. 104) and Aukutsionek *et al.* (2003, p. 4)

The redistribution of shares has been in progress since the financial crisis. The concentration of ownership and control in industry, particularly the concentration in the hands of nominal owners, irrespective of insiders or outsiders, can be observed. Moreover, in this period, foreign companies have extended their ownership. In this manner, ties on property rights have become an extensively integrated mechanism between companies at the core of the business group (Dolgopyatova, 2002, p. 39). Simultaneously, due to the bankruptcy and negative performance of commercial banks, the financial companies' ownership has been stagnant, and their assets have been transferred to the large-scale industrial holding companies.

This paper focuses on the ownership of big business in Russia (Pappe, 2003). The big business in Russia includes independent companies (single economic units, which cannot be divided), the corporate form of multiple companies tied by production/sales (specialized integrated business groups) and integrated business groups (the entire business belonging to various industrial/non-industrial branches). Such big groups were formed especially in the late 1990s; the main ownership and control were taken on by the core companies (holding companies), and in addition, the governments preserved their influence. However, changes have arisen with regard to ownership and control in the economic recovery period following the financial crisis. From the mid-1990s to 2001, the integrated business groups occupied the main position in the big business.

While the integrated business groups continue to exist, their form has changed and the main industrial (energy) companies have occupied the core.¹³ Fifty or more big businesses existed in the spring of 2003, which include not only the major fuel and raw material companies but also companies in the processing sectors. The big business has not necessarily taken the single JSC form; rather, it is composed of a complicated ownership structure, which includes offshore companies. From the viewpoint of influential individual entrepreneurs, the big business has not changed its structure. In brief, offshore companies and concentration in the hands of influential individuals are, by and large the common characteristics of a big business.¹⁴ As the business group expands, its structure of ownership and control becomes more complicated.

A question arises with respect to the types of correlations that exist between ownership and control of the company? According to the research on defense companies by ISEPN, the following features have been observed with respect to control (Table 3): 1. Managers have more controlling power than their holdings, 2. The controlling power of the labour group and other owners is conversely small compared with the ratio of shareholding. Therefore, the authority of the company's directors possesses the most substantial power, and the labour group has the least influence. The formal rights of outside owners are restricted, often being dispersed, and they cannot compete with the board of directors. In many cases, the board of directors governs the labour group and occasionally, the state holdings. In a great majority of non-state JSCs, the board of directors is actually and formally 'an owner' (Ryvkina *et al.*, 2003, p. 44).¹⁵

Table 3 Interrelationship between shareholding and control

	(%)	
Shareholders/Stakeholders	Rate of shares	Rate of control*
State	24	24
Managers	16	41
Employees	20	6
Others	40	29
Total	100	100

* Rate of control: the response rate to the question,
'Who has the power to make the main decisions in your company?'

Source: Ryvkina *et al.* (2003, p. 44)

3.2. Main features of ownership and control

This paper now proceeds to summarize the main features of ownership and control, based on the evolution of shareholding after the financial crisis.

First, despite its decline, the ownership/control of insiders has been maintained. During the first period of privatization, which ended around 1995, the ‘insiders’, i.e. the employees and managers of companies tried to control the company and faced opposition from the outsiders. However, as ownership was formally established, the owners, who had an understanding of the information pertaining to the company and were involved in the decision-making process, came to be regarded as insiders in the company, and concentrated control by the new insiders (managers who turned into large-scale outsiders or lawful owners) was established (Dolgopyatova, 2002, pp. 38-40).

Second, the concentration of capital has been strengthened. According to Dolgopyatova (2002, p. 39), 60-70% of ownership in large-scale privatized companies is concentrated in the hands of managers. The average shareholding of the three major shareholders in the Russian companies is approximately 75%. According to the World Bank (2004, pp. 10-13), there were 22 executives controlling Russian industrial enterprises that had more than 20,000 employees and an annual sale of over 700 million dollars. Buzgalin and Kolganov (2003) also provide the indirect data of high concentration of stock ownership (Table 4).

Table 4 Concentration of ownership

(%: the enterprises’ response rate to the question on concentration)

	Number of respondents	% in equity capital					
		1995		1998		2000 (estimate)	
		Average	Median	Average	Median	Average	Median
Biggest shareholders	213	26.2	22.0	27.6	23.0	28.8	24.2
Three biggest shareholders	213	40.4	40.0	44.5	44.4	46.5	46.3

Source: Buzgalin and Kolganov (2003, p. 246)

The dominant owners are different from the maximum owners of the companies. When outsiders are dominant, the majority of them become the maximum owners. When insiders are dominant, however, the maximum owners are insiders in the half and, in the other half, the maximum are the outsiders or the state. In the case of insider control, the tendency towards dispersion of ownership is strong, whereas in the case of outsider control, the concentration tendency is strong (Kapelyushnikov, 2000).

Third, regardless of the ownership type, managers’ control is generally strong; they can convert themselves into owners. The conversion of managers into owners implies a change from the separation of ownership and control to the coinciding of ownership and control. For example, the research by the Central Econometrical Research Institute has also concluded that managerial control

is strong in Russian companies (Kleiner, G, *Nezavisimaya*, 8 May 2001). In industrial sectors, 3.7% of the shares belong to the board of directors (managerial group), 4% are held by the JSC itself and even this part is under the control of the managerial group. While the state owns 12.8% and the employees possess 20.4%, most of the shares are entrusted to the managerial group either voluntarily or involuntarily. In this manner, the managerial group possesses more than 40% of the shares and no individual shareholder possesses more than 17%. As a result, the managerial group does not feel responsible towards the shareholders' general meeting, and it also does not take any responsibility for the labour group or even for the markets.

Fourth, the corrosion of insider ownership and the concentration of outsider ownership have resulted in different types of ownership depending upon the type of industry (Kapelyushnikov, 2001). The employee holdings are high in the light industry and holding companies are progressing in the construction of the material and national defense sectors. The ownership of the managers and business partners is high in the food industry. The state holdings are high in the machine-building and electric power sectors, and the non-financial company holdings are extremely high in the metal sector. Overall, in the case of the industrial sector, which has a high rate of recovery and growth, ownership by incorporated companies is high, whereas in the case of the stagnating industries, ownership by insiders is high.

Fifth, employees exert their influence as stakeholders. Employees possess quiet control as stable insiders. Unlike outside minority shareholders, they do not request dividends because they consider that dividends are paid from their wages. In other words, they have an interest in the maintenance of the welfare programs and the offering of social services rather than dividends, and they try to influence corporate management for their welfare goods. The company offers its employees not only temporary assistance but also regular assistance and even offers them housing, meals, etc. Such public goods are also provided by the local governments. Local governments and employees influence corporate management in their pursuit of the security of social services (Table 5). Table 6 also depicts the ratio of payments in kind in the total sum of wages. Although the company welfare provision becomes a means to secure the co-operator, who is silent for the managers, when the concealed power of the employees is ignored, labour conflicts arise and quiet shareholders may turn into a counterforce. Therefore, while the degree to which employees as stakeholders can affect decision-making is low, some companies (trying to avoid restructuring) have tried to keep employees from a managers' risk evasion action. Such influence, however, is not stable. After the financial crisis, employees' influence declined remarkably and led to 'spontaneous restructuring' (Kosals, 2001, p. 2) which is still in progress. Although employees can influence their wages and employment through workers' contracts, managers¹⁶ have a discretionary power, while governments and trade unions have a limited power over the wages (Kapelyushnikov, 2003a, 2003b). In this respect, the control of the Russian company can be termed as the managerial model. The employees' influence on their wages is weaker than what it appears.

Table 5 Assistance to employees

(%: the enterprises' response rate to the question on assistance)

Type of assistance	1994	2000
Regular assistance		
Commuter allowance	26.6	16.3
Food expense assistance	49.2	21.1
Manufactured goods price subsidies	6.6	2.0
Housing allowance	12.7	7.8
Baby and child care assistance	43.9	16.9
Added pension	7.4	5.9
Temporary assistance		
Physical support	79.7	70.7
Charges/Payments	45.5	54.7
Medical service payments	48.4	28.3
Retirement payments	73.8	62.9

Source: *Ekonomika i Zhizn'*, No. 38, September 2002, p. 2.**Table 6 Social service provided to employees**

(%: the enterprises' response rate to the question on social service provision)

Type of assistance	1990	1994	1998
Meals	55	50	41
Health care	64	63	56
Leisure facilities	62	56	44
Vocational education	78	71	59
New housing construction	45	34	18
Kindergarten	66	54	32

Source: Guriev and Ikes (2002, p. 223)

Sixth, the huge integrated business groups continue to exist. Within the group, ownership and control of industrial companies are further expanding. The powerful enterprises in these groups have earned a stable income from the export business. As a result, foreign investors are becoming more interested in the shares of the powerful enterprises. This phenomenon led the Russian enterprises to observe the law. Further, it led to the organization of a stable corporate governance so

as to develop a good international reputation (Yakovlev, A., *Ekspert*, No.3, 26 January-1 February 2004).

The evolution of ownership and management has spontaneously shown some changes and adaptation to the market environment, which has resulted in a turnover in management. During 1992-1999, 71% of the enterprises received new top executives resulting in a new generation of top executives. However, 24% of them maintained their position even after privatization (Radygin and Arkhipov, 2000, p. 121), and even the red managers of the former socialist enterprises improved the efficiency of business management by learning the process by themselves (Yakovlev, 2004). Based on the research of the Russian Economic Barometer, 'approximately 40% of the CEOs were the same as those appointed in the Soviet times, and 60% were 'new' directors who came to power after the implementation of market reform. There exist two polar segments in the population of Russian industrial firms—the 'unstable' segment, where CEOs were replaced repeatedly within the span of rather short intervals and the 'stable' segment, where no renewal of CEOs had been made for a long time' (Kapelyushnikov and Demina, 2005, p. 14).

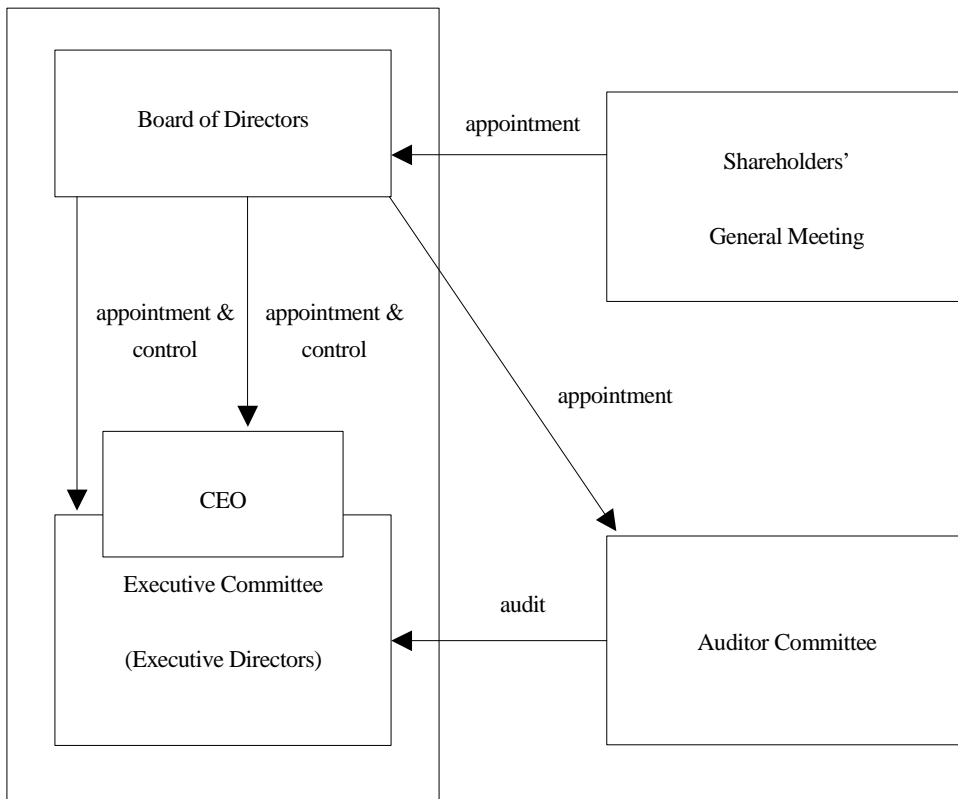
Corporate governance in Russia is not merely a conflict of insiders and outsiders; it is the conflicts and harmonization of interests among the various stakeholders, the market environment and the learning process of corporate managers.

4. Characteristics of Russian corporate governance

4.1. A comparison between models of corporate governance

This paper sketches the Russian corporate governance in comparison with the standard alternative models of corporate governance, i.e. the Anglo-American model, the German model and the Japanese models.¹⁷ Since corporate governance reform has become the watchword in the US, the UK, Europe and Japan, at the very least, we can observe practical international convergence and ideological convergence.

In the Anglo-American model (Figure 2), shareholders' authority and the institutional investors usually have a strong influence, and the managerial power is concentrated in the hands of the CEO. At the same time, in the US, the following changes are taking place: 'appointment of a larger number of independent directors to boards of directors, reduction in overall board size, development of powerful board committees dominated by outsiders, closer links between management compensation and the value of the firm's equity securities, and a strong communication between board members and institutional shareholders' (Hansmann and Kraakman, 2004, p. 51).¹⁸

Figure 2 Main administrative organization of companies in America

In the case of the German model (Figure 3), management and supervision are separated and shareholders and employees jointly select the board of auditors. Under globalization, 'co-determination now tends to be defended in Germany' (Hansmann and Kraakman, 2004, p. 39). However, the Japanese model (Figure 4) is similar to the Anglo-American model, both superficially and legally (after the amendment in 2003). However, insiders have a strong influence, and a certain type of harmonious interest permeates among insiders (managers and employees) within the enterprise or the group. Generally speaking, the shareholder-oriented model of the corporation is now influential, although its criticism has often been insisted upon in Japan.¹⁹

The Russian model (Figure 1) indicates some legal and practice-based similarities with the Anglo-American model. The CEO has a strong authority in the organization. However, 'Russia could well progress towards a German-Japanese network-based model reflecting a stakeholder approach' (Puffer and McCarthy, 2004, p. 23). The Russian model has its own characteristics. The coinciding of ownership and control can be regarded as specific, and the embedded historical and

cultural values, such as a mistrust of outsiders and worker representation, appear to be significant characteristics of the Russian stakeholder model.

When viewed from the legal aspects and governance practices of ownership and control structures, corporate governance in Russian enterprises shows unique characteristics, which are different from those of the Western enterprises. Its typical characteristics are as follows: 1) an extraordinarily high degree of concentration of ownership, 2) the closed character of major enterprises (although they are formally open JSCs), 3) the formation of business groups by the companies, 4) conjunction of ownership and management, 5) internal financing, 6) informalization of the board of directors, 7) absence and inefficiency of external mechanisms and 8) the state-oriented model in governance. These characteristics are attributed to the Russian transformation, history and culture (Radygin, Entov, and Mezheraups, 2003, p. 59).

Figure 3 Main administrative organization of companies in Germany

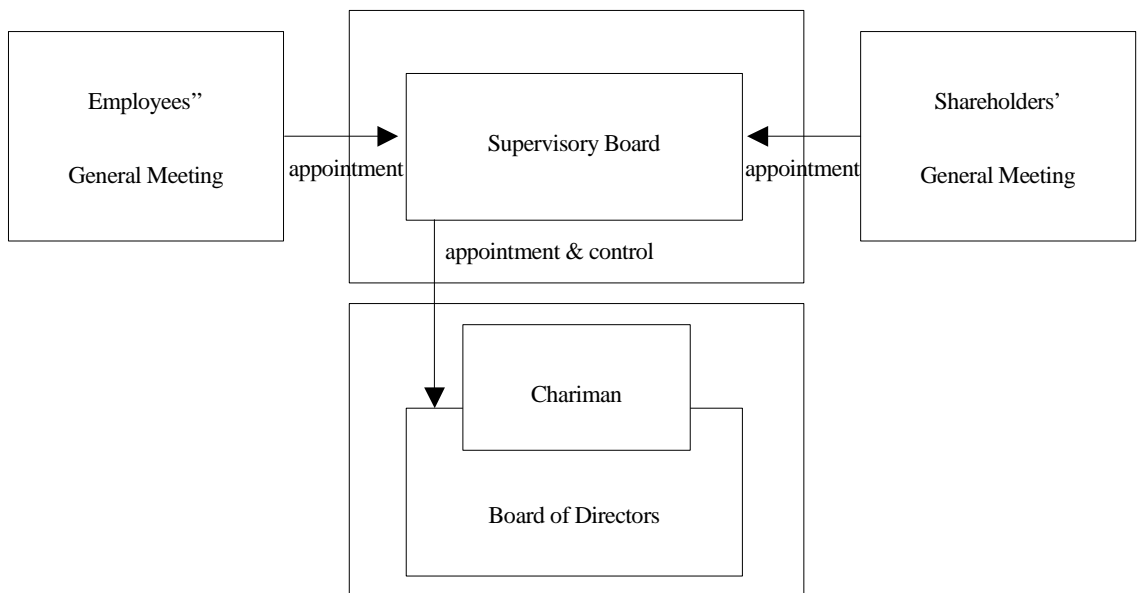
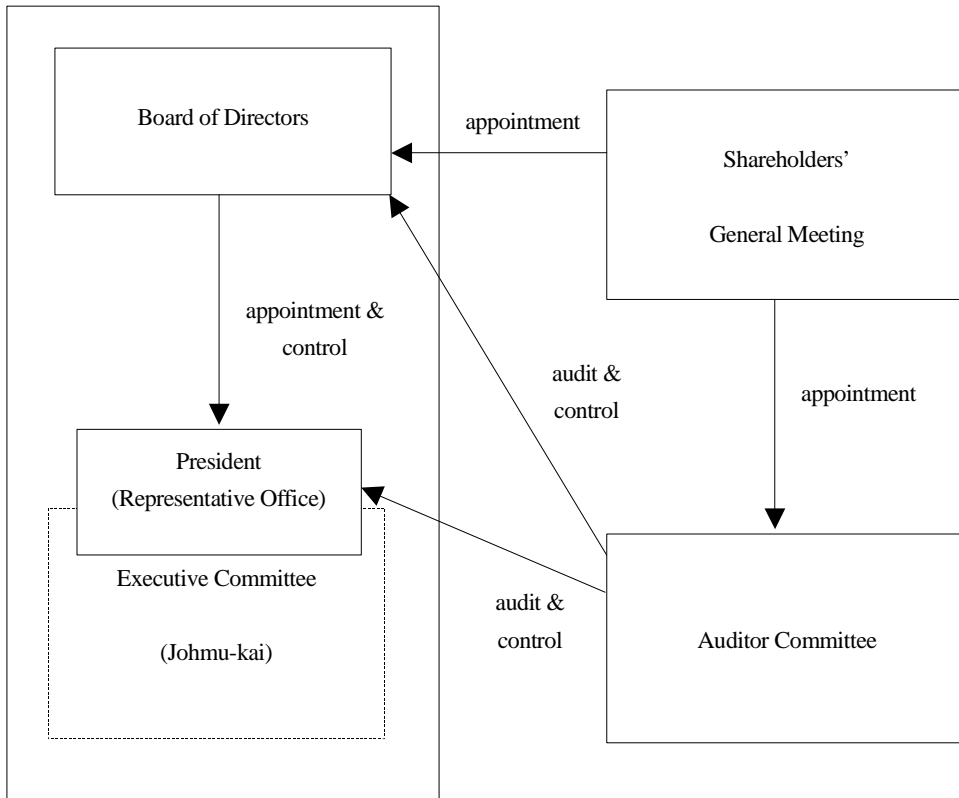


Figure 4 Main administrative organization of companies in Japan



4.2. Conditions for governance

The following four conditions maintain the above characteristics of corporate governance.

First, enterprises operate in the undeveloped capital markets. Privatization has not created wide-ranged and highly fluid securities markets, and, furthermore, the development of the corporate bond markets is limited. JSCs do not sufficiently disclose all the information related to their financial statements; therefore, investors are unable to receive credible information on profits and/or deficits. Arrears, barter payments and complex financial relations with subsidiaries make this information more difficult to comprehend. The strategic shares are traded through closed negotiations. The immature securities markets and conflicts over corporate control through ‘informal operation’ restrict the possibility of implementing the agency model in which competitive market mechanisms and shareholders control the managers.

Second, stakeholders have responded to the incomplete institutions. The enforcement of the law on the ownership protection (protection of the shareholders’ rights) has been inadequate and

'opaqueness' of the ownership relations can be constantly observed. The shareholders' rights, particularly those of the minority shareholders, have not been protected by various formal and informal means. Employees have unexpectedly become shareholders of their companies, and they do not recognize themselves as joint owners or as investors. In such cases, corporate governance that guarantees dividends and profits maximization becomes difficult. The abuse of power on the part of the managers does not give rise to agents who are responsible for efficient management. The acquisition of the strategic shares by means of 'shares-for-loans', the close ties of the government organizations and the enterprises that guarantee these acquisitions, the collusion between municipal authorities and municipal judicial bodies in order to exclude the outside investors, particularly foreigners, administrative warnings or physical sanctions to employees who have sold their own shares to 'outsiders' and manipulation of the shareholder register are often carried out. The above processes ignore the original functions of the issue of shares. Besides, by not premising the issue of corporate bonds as well as avoiding bank credits, the enterprises impose limitations on financing from outside. Even if enterprises form huge integrated business groups, they are nothing but 'segmented capital markets that exist in each group'. As a financial base, there exist internal finance and the government cash injection. Arrears and complicated chains of non-monetized payment replacing the liquid capital are added to them. These financial routs and methods are conditioned by the underdevelopment of the Russian capital markets and the poor service provided by banks.

Third, as a result, in Russian enterprises, the institutional norms and the insufficient development of market relations are compensated for by informal mechanisms (from non-market relationships to the black economy). Further, the profits are ambiguously used through offshore means.

Fourth, the relations between the enterprises and the government, political interference in the enterprises and the (personal or literal) political accessibility, all remain intact. Regardless of the type of ownership, the management of the enterprises is highly dependent on the central and the local governments and their economic policies.²⁰ In order to enhance their own political role and to reinforce the position of their own local authorities' candidates for election, the enterprises acquire the strategic shares of local leading companies. These situations can be observed in Siberia, the Far East and Southern Russia. Therefore, the future prospect of corporate governance reforms in Russia lies not only in the strategic policies implemented by the legislative and executive bodies but also in the de-politicization of the enterprises. Despite the legal system reform, law-and-order state (federal) organizations cannot maintain neutrality, and it is difficult for them to maintain judicatory objectivity because the legal stuffs of bureaucrats and companies are incompetent and inexperienced. For example, it is doubtful whether the anti-monopolistic regulations for monopoly and oligopoly function effectively in the Russian economy (Pappe, Ia., *Ekspert*, No.41, 1-7 November 2004).

The four above-mentioned conditions imply that corporate governance reforms cannot be successful only through legal system reforms and their enforcement. Although the Russian rules of governance have become a hybrid convergence between the Russian national rules and the US and

European rules, the practical governance has created the national model. Therefore, theoretically, the following two factors play a decisive role in the corporate governance of Russia. First, all the conditions such as underdeveloped capital markets, incomplete market institutions, informal norms of institutions, inertial relations and networks, imply that the institutions under corporate governance might, in practice, be led by path-dependent relations (Oleinik, 2004). The initial rules and institutions affect the choices of the subsequent path and policies. When the imported formal institutions did not work effectively, and when it took a long time to adapt to the new environment, informal institutions and the personal networks embedded in the Russian society formed their own norms. Second, in parallel with the path-dependent factors, the decision makers and stakeholders have consciously chosen the Russia-specific regime under the asymmetrical information and the opportunity of utilizing institutions (Gel'man, 2004).

5. Evolution of corporate governance: normalization and harmonization

5.1. Normalizing legal acts

The 1998 financial crisis, the institution-building after the crisis and the corporate governance reform that began in 2000-02, advanced the normalization of corporate governance, and 'management has undergone qualitative changes—not only with the coming of new people, but also with the learning of the old directors by adapting to a new environment' (Yakovlev, 2004, p. 23).

First of all, the legal institutions have been improved. The capital dilution, the protection of shareholders' rights, particularly the freeze-out of minority shareholders, overseas capital transfer (capital flight) and the enforcement of disclosure requirements (Berglof and Westin, 2000), which were seen as the problem areas of corporate governance, were improved between 2000 and 2002. The results can be observed in the amendments to the Law on JSCs, offshore regulations (*Kommersant*, 10 December 2002; *Vedomosti*, 10 December 2002),²¹ the information disclosure law and the administrative sanctions. In the case of minority shareholders, the risk of losing influence has decreased.

In 2001, based on the 'OECD Principles of Corporate Governance', the 'Code of Corporate Conduct' was formulated. The final version, formulated by the FCSM and approved by the government in November 2001, had an advisory (recommendation) character (*Finansovye izvestiya*, 9 April 2002) and is regarded as the best practical standard of corporate governance for JSCs with over 1,000 shareholders. Reactions to this code from the business community varied from complete approval to complete negation, the argument in favour of the latter being that the code would strengthen the bureaucratic tendency of the economic management. According to the survey conducted in October 2001 with more than 100 top executives of the big companies, the respondents were equally divided with regard to the pros and cons of the code. While many of the big corporations such as Yukos, Sibneft and the United Energy System of Russia that had adopted their

own rules in order to improve their investment reputation welcomed the code, many top executives who expected the code to provide the mechanisms for protection from the shareholders' pressure or the lobbying of other stakeholders, expressed disappointment. This code specifies the authority of the board of directors and its functions include the creation of the current/financial risk management system and the establishment of various committees. A corporate secretary system, which controls the company's information policy, the drawing up of the documents for the shareholders' general meeting and an auditor system, which supervises the company's financial and management plan, were proposed (Dolgopyatova, 2002, pp. 58-60).²² In particular, in order to protect the shareholders' rights and to avoid corporate bureaucracy, the corporate secretary system under the board of directors requires a legal basis (*Ekonomika i Zhizn'*, No. 24, June 2005).

At the same time, the EU expansion has served as a positive incentive for the formal harmonization of the Russian company law with EU rules. A. Radygin firmly asserted that 'the model of European company adopted in 2001 after a 30-year discussion would not present a problem for the corporate law of Russia' because the Russian legislation has many similar standards. However, in substance, the harmonization of rules relating to corporate governance in Russia and the EU has certain shortcomings such as transparency, enforcement, judicial systems and others (<http://www.iet.ru>, 23 February 2005).

In addition to the issues mentioned above, in the government's 'Medium Term (2002-2004) Socio-Economic Development Program of the Russian Federation' (2001) and '2003-2005 Socio-Economic Policy Program', issues such as protection of shareholders' rights, management responsibility and transparency of organizations were raised, and comprehensive legal system reform came to be in progress (Dolgopyatova, 2002, pp. 60-63; Radygin, Entov and Mezheraups, 2003, p. 139).

5.2. Normalizing corporate behaviour

The business communities themselves are preparing a directive for corporate governance. 'The Charter of Corporate Business Ethics' by the Russian Union of Industrialists and Entrepreneurs (*Vedomosti*, 21 October 2002) urges the need for protection of ownership, compliance with the legal system and dispute settlement through negotiation. The charter presents eight guidelines: 1) business should be carried out based on the principle of fairness, 2) property rights should be inviolate, 3) the law should be complied with, 4) social tension should not be encouraged, 5) no pressure should be put on judicial bodies, 6) enterprises should not compete illegally, 7) false information manipulations should be avoided and 8) resolution of corporate conflicts should be sought through negotiations. Arbiters, however, are elected by the business community itself, and the decisions made are not legally binding. In March 2003, the National Council of Corporate Governance was established, and since then, the business community is displaying a positive attitude towards corporate governance reforms (*Nezavisimaya*, 22 December 2003). The recent research on the Russian

corporate governance (The Russian Institute of Directors, 2005) indicates an improvement in the transparency of enterprises.

In connection with corporate behaviour, the CSR has become a popular topic world-wide. Corporate governance in Russia is also inseparably related to the CSR (Mizobata 2004b). The Yukos affair, in particular, raised grave issues on compliance with the legal system, social justice and transparency in corporate governance. While the impact of globalization (the United Nations, the EU and others) and the global pact are decisive in the Russian CSR management, the stakeholders' interests are also related to the CSR. Managers have intensified social programs with improvements in labour conditions and workers' training in order to raise the company's reputation and establish corporate identity. Employees and regional residents become direct beneficiaries. The state (the regional governments) has actively supported this process in order to decrease their financial burden. Therefore, various stakeholders have supported harmonizing with the West on the CSR.

In order to realize the CSR, managers have taken considerable interest in social investment and policy. According to the Managers' Association, in 2003, the average social investment per employee was 28,300 rubles, its ratio in the total sale was 1.96% and its total profits were 11.25%. The main targets of social investment were the creation of new jobs, corporate in-service training and a healthy corporate system. While intra-firm programs were dominant with respect to social investment in 2003, investments for the local community such as the protection of environment showed an increase in 2004.²³ In the enterprise town, in particular, the CSR is indispensable for the local residents. A comparison of the CSRs in Russia and Europe clarifies the Russian corporate structure. In contrast to the CSR in Europe where companies and the local community play a central role in stimulating the CSR, in Russia, the central and local governments have a strong influence on the CSR. In addition, since the concept of a CSR that is common to all the stakeholders has not yet been established in Russia, there exists a barrier with respect to co-operation among businesses, communities and the government (*Ekonomika i Zhizn'*, No. 1, January 2005). Moreover, since the Russian enterprises have evolved from the Socialist system, the CSR is regarded as an important sphere of insiders' corporate control and negotiation between business and the government.

Normalization and harmonization of the standard corporate model in the enterprise have gradually evolved after the financial crisis because many enterprises have strongly been aware of competitiveness (Mizobata, 2005). According to the Russian Economic Barometer, the utilization standard of the production capacity, labour utilization rate, stocks of finished products and order-book level have risen and are reaching the normal level. A 'tranquil' normalization process is in progress. Investment has increased, bank borrowing and the ratio of long-term loans in the commercial loans area show an upward trend (*Ekonomika i Zhizn'*, No. 11, March 2005). The credit per investment increased after 2000 (Table 7). With respect to financing, the volume of shares and corporate bonds is on the rise (Abramov, 2003).²⁴ The stock price of some growing companies (oil, telecommunication, food, etc.) has sharply grown, and the dividends that are paid are also on the rise (*Vedomosti*, 12

November 2003). Dividends²⁵ are estimated to be approximately 20% of the net profits in oil companies (Kostikov, 2003, p. 449).

Table 7 Credit/Investment (%)

1997	67.5
1998	103.6
1999	89.0
2000	65.5
2001	82.1
2002	97.5
2003	115.1

Source: Goskomstat RF (2004)

Deregulation in stock trading has multiplied mergers and acquisitions (hereinafter M&A) (*Ekspert*, No. 41, 3-9 November 2003). The year 2003 witnessed a drastic increase of M&A both in terms of number and cash. In the first half of 2003, 250 cases were registered, and the number was similar to that of Japan (Guidebook..., 2004, pp. 26-29). In 2004, the total transaction values of M&A reached 22.86 billion dollars, and increased by 18.1% annually.²⁶ Of the total sum, approximately 80% comprised M&A among big businesses such as LUKOIL-ConocoPhillips, Rosneft'-Yuganskneftegaz, Mosenergo, which was taken over by Gazprombank, Del'taBank-GE Consumer Finance, NIKoil-YralSib and others. The oil and gas sector comprised 62% of M&A. These transactions, however, are not always based on the functioning legislations (*Profil'*, No. 4, 7 February 2005, pp. 60-62). Multinationalization of Russian enterprises also promotes normalization.

Dispute settlement by the arbitrations (arbitrazh) court has become common to the enterprises. More than 60% of the respondent enterprises have been involved in the arbitration process, at least once in the past three years, and a quarter of the enterprises have been through the arbitration process more than five times. The more the enterprise expands, the greater the tendency to choose arbitration for the resolution of corporate conflicts (Golikova *et al.*, 2003).

The above-mentioned normalization and adaptation to the market environment were based on the peculiar way of learning by doing; this 'had little to do with government policy and was rather related to the stronger competitive pressure in the course of Russia's integration into the global market' (Yakovlev, 2004, p. 24).

6. Evolution of corporate governance: divergence

6.1. Diverging corporate reform

According to the research by the Managers' Association and the Russian Directors' Institute in 2002 (Golikova *et al.*, 2003), despite gradual changes in quality, drastic changes in corporate governance still cannot be observed. Most managers have retained their former position. 37% companies practiced active management, and such companies have concentrated in large cities and the financial sector. Dividends were not paid by 60% companies. Although almost all the companies were aware of the Law on JSCs and held their own legal department, a majority of the small enterprises were ignorant of the legal system. With regard to corporate governance, the Russian society appears to be segmented (fragmented), and companies can be divided into the following two categories: legally adapted companies with market-oriented management, and legally ignorant companies with passive management. In brief, the normalizing trend has kept pace with the preserving trend, which causes the Russian corporate governance to diverge from the Western model.

Normalization is still uncertain, and the force to retain the existing Russian corporate governance is strong. Above all, the fundamental conditions for corporate governance—the undeveloped capital markets, informal mechanisms and the close ties between the government and the enterprises (interference by the governments and bureaucrats)—have firmly persisted. There have been numerous scandals that question the responsibility of the corporate executives since 1999.²⁷ The Yukos affair can be regarded as an example of one of the biggest such scandals. The government has continued to pressurize the enterprises. It appears that because Yukos is regarded as a company that places importance on disclosure to its shareholders, the Russian Government appears to pressurize it against corporate governance. This pressure contributes to the deterioration of incentives for transparency and openness of corporate management.

Re-examination of privatization also indicates double-edged effects. As the shares-for-loans privatization in 1995-1996 was advantageous for oligarchic private capital, it has often been criticized for its rent-seeking and illegal character. Further, in order to authorize the proprietary rights, the privatization process must be examined by authorized organizations. Re-examination of privatization has been particularly inspected with respect to the process of the Yukos affair. According to the data by the Board of Audit, in the 8 'shares-for-loans' privatization deals, the initial price was unfairly cheap and symbolic, and most of participants in auctions guaranteed the deal mutually and illegally. However, in false privatization, it is not difficult to return the privatized assets in the hands of the former state's hand because after the auction, some of the shareholders have already transferred their ownership to the new third parties based on the lawful transaction. As a result, on taking into account the market price of the privatized assets, the composition compensating for the losses of the government is possible under the negotiation of the state and business (*Profil'*, No. 5, 14 February 2005).

Therefore, a series of legal system reforms alone did not completely resolve the problems of corporate governance. There are still many areas in which the legal system is undeveloped. For example, the legal system has not been fully reformed in areas such as the management structure of a closed JSC whose shares are owned by one person, the legal system for information disclosure and the restructuring of JSCs and disputes among shareholders (Radygin, Entov and Mezheraups, 2003). Similarly, the following should be addressed in the future: 1) the law on limited companies must be developed as an option for small companies, 2) the restructuring mechanism of JSCs should be improved,²⁸ 3) the merger and takeover mechanisms of JSCs should be improved, 4) the illegal ownership structure in many JSCs (incomplete shares registration), which mainly relates to corporations established before 1996, should be normalized and 5) there should be measures to guarantee the enforcement of the decisions made by the court.

Despite the infiltration of the arbitrations court, some companies tend to choose informal institutions like mutual negotiation due to a lack of trust and expensive costs. In the case of dispute with the public authority, it is apt to violate the interests of private companies.

Despite the improvement of the litigation system, the questionnaire conducted by V. Radaev indicated that 24% of the respondents would launch legal action in cases of a breach of contract, and 11% would resort to violence to ensure the implementation of the contract. In other words, confidence has been built neither in the market, nor in the legal system (Kornai, 2003). In recent years, state organizations have often infringed on the rights of corporate governance and the law remains inefficient from the viewpoint of the protection of the enterprises' interests in dispute with the state. The enterprise would bring a particular action to the court in case of a dispute with the state only when the case is clearly in favour of the enterprise. With the interaction of the formal system and the informal system, the latter's dispute settlement mechanisms prevail. From January 2003, the Corporate Ethics Committee of the Russian Union of Industrialists and Entrepreneurs began to receive complaints from companies whose rights had been infringed (Yakovlev, 2003).

Although corporate control markets (M&A markets) are developing at a rate comparable to that of developed economies, the legal institutions are considered to be insufficient. In the summer of 2004, the Law on JSCs amendment was passed in the first reading according to which, more than 90% shareholders have the right to automatically buy out the remaining shares. As a result, minority shareholders will be squeezed out and a further concentration of shares is predicted because in Russia, the automatic buy out corresponds to big businesses such as TNK-BP, Severstal and others. There exist grounds for amending the law. Minority shareholders' rights are regarded as inconsistent. On the one hand, since many companies are reluctant to pay dividends, the fundamental rights of shareholders are not fulfilled; on the other hand, the Law on JSCs²⁹ in Russia is said to provide overestimated rights to minority shareholders. Minority shareholders abuse their rights, and the disputes of almost all companies are brought about under the pretext of minority shareholders. They can make inquiries regarding the shareholders' list and the companies' information and can easily take

action in court; the Law on JSCs makes it possible for them to pirate the company (Volkov, V., *Izvestiya*, 15 July 2004). Consequently, minority shareholders and the Western investment funds stand against the 2004 amendment (*Ekspert*, No. 34, 13-19 September 2004). Shareholders' rights have not yet been transparent and unstable and lobbying has continued to function over the ownership. It would be realistic to state that the conflict between the majority and minority shareholders and the inefficiency of the puppet boards of directors have not been resolved.³⁰

Hence, the reform is criticized as an 'act'. Majority of the Russian enterprises do not have an efficient corporate governance and only 15-17% of the Russian enterprises possess an intimate knowledge of the Code of Corporate Conduct or its world-wide practice. Furthermore, one third of those enterprises are ready to introduce innovative practices. Therefore, overall, only 10% of the enterprises achieved positive results in the area of corporate governance (Radygin, Entov and Mezheraups, 2003, pp. 56-59).

6.2. Diverging corporate governance

The changes in investment cannot be exaggerated. In the case of Russian enterprises, the ratio between the internal and external fund is 12:1. Among the banks' assets, only 3-4% of credits exceed one year. The securities markets do not have any effect on the actual economy, and the debtors are limited to large corporations (Neschadin, A., *Vedomosti*, 10 November 2003). According to Mizobata (2005), no enterprises of investigation registered themselves in the financial markets for fear of the risk of losing ownership, and approximately 70% of the investment comes from the internal own funds. The investment influx into the securities markets may not be the result of governance but the result of the investment overheats (*The Moscow Times*, 19 February 2004).³¹ As Table 8 indicates, in Russia, the share of the own funds is dominant and has been increasing. Although bank credits have increased, the banks are not interested in the long-term investment in the enterprises, and they cannot monitor corporate governance as stakeholders. The issue of securities, particularly in the Russian capital markets, is concentrated only in a small number of large enterprises (78% of the total amount of the market capital and 98% of the turnover in the stock exchange) (*Ekspert*, No. 2, 19-25 January 2004). Not all the enterprises are included in the capital markets, and the markets are considered to be clearly segmented.

The empirical survey on management performance compared insiders' (i.e. managers') control and outsiders' control; the latter's business efficiency was not always better than that of the former (Kapelyushnikov, 2000). Even with a relatively good governance and management control (and its formation process), using a formal and informal means violated the shareholders' general meeting. The division between the board of directors and the executive committee became ambiguous and top management did not bear any responsibility to the shareholders, employees and consumers. The managerial control is termed as an 'authoritarian mechanism'. There exists a possibility of dispute within the enterprise because of the lack of decisions adopted in the information chain. There is also

a risk of losing uniformity as it is difficult to adjust the opinions among the organizations inside the enterprise. The absence of management responsibility still persists, and it may cause a moral hazard of managers (Kleiner, G, *Nezavisimaya*, 8 May 2001; Interview with Kleiner, G. in February 2003).³² Kleiner (2002) stressed that management cannot adjust the entire system due to the lack of a strategy.

Table 8 Financing investments

	1995	1997	2000	2002	2003
					(%)
Own funds	49.0	60.8	47.5	45.0	45.6
Profits	20.9	13.2	23.4	19.1	18.0
Depreciation reserve	22.6	26.5	18.1	21.9	23.8
External funds	51.0	39.2	52.5	55.0	54.4
Budgets	21.8	20.7	22.0	19.9	18.7

Source: Goskomstat RF (2004, p. 163)

Although the impact of the CSR can be regarded as harmonization with the West, the stakeholders' influence on the CSR characterizes the Russian corporate governance. The government has the largest influence on the CSR strategy, and the next influential stakeholder is the company itself, i.e. the main shareholders and the managers. Some regional governments have concluded socio-economic agreements with large enterprises, and the regional enterprises regarded the relation with the regional authority as a deciding factor for survival (Kurbatova and Levin, 2005, pp. 68-69). As opposed to the European model, both the employees and the local community have a partial effect on the CSR, and NPOs and NGOs do not function in practice in Russia (*Ekonomika i Zhizn'*, No. 1, January 2005).

Despite the superficial harmonization, Russian corporate behaviour is obviously distinct from that of the West.

6.3. Perspective of evolution

In Russia, trust building with regard to policies and the legal system is indispensable because trust can integrate fragmented institutions. Corporate governance reform is only made possible by maintaining trust. Since the financial crisis in 1998, two favourable factors for trust building have been in play.

The first factor is that under the Putin government, which aims for a strong state, economic recovery has been sustained and competition has forced not only dominant managers but also all the stakeholders to adapt to the market environment. The corporate behaviour and the promotion of business efficiency (restructuring) have been recognized as indispensable for the further development

of companies. The corporate ability to adapt to the market environment with investment resources and accumulation of internal funds has been improved. Secondly, after the financial crisis, particularly after 2000, the legal system of corporate governance has been comprehensively reformed, although there still exist certain areas where the reform is insufficient. The reforms, including the enforcement of the legal system, are in progress and companies are highly interested in this issue.

However, in actual corporate governance, favourable factors do not necessarily lead to reform because 1) the foundation of trust lies in the personal networks between the government and the corporate managers, and among managers and 2) the informal institutions still play an important role in reducing transaction costs. Although many managers have been replaced within short intervals due to a lack of formal trust, many managers have also been retained in their positions for the traditional network. It can be stated that there are segments in corporate governance reform and the market adaptability of the managers. In addition, the corruption and insufficient dialogue between business and bureaucrats make the formal institutions fragile (*Profil'*, No. 21, 6 June 2005).

Despite the acceptance of deposit insurance, the financial infrastructure is inefficient and banks cannot play the role of a stakeholder in corporate governance. Large-scale commercial banks are limited to a handful of group (oligarchic) banks. They have close ties with energy enterprises and the political authority, and their loan capability remains inadequate and is concentrated in the group. This implies that outside monitoring is insufficient because of their low competence and the financial market is fragmented among the groups. At the same time, many top banks are not always transparent because some of them have opaque main shareholders such as unknown OOO or closed JSCs.³³

Since the characteristics of corporate governance in Russia are based on the evolutionary transformation, Russian historical and cultural factors are believed to be retained in the medium term in the state interference and corporate bureaucracy.

7. Conclusion

After the financial crisis in 1998, corporate governance in Russia has drastically changed and a legal system equal to that of the developed countries is being built. The authority of shareholders has increased and the litigation system over ownership and control of the enterprises has improved considerably. There also exists a strong and stable state power in the background. However, the actual corporate governance has not changed as much as the system. Control of managers surpasses that of general shareholders, and the opaque ownership relations in big business and corporate groups still remain. Managers and enterprises have concentrated their shareholding in order to consolidate their control. Furthermore, intervention in corporate governance by the government can be observed both in central and local regions and the government has had a significant impact as a stakeholder. The significant corporate governance reforms do not necessarily cover all the Russian enterprises.

Small- and medium-sized enterprises and closed JSCs lie outside their range and in many cases, even in open JSCs, their financial statements are not sufficiently disclosed. Financing in capital markets is concentrated on the limited number of large enterprises and banks. In that sense, the corporate governance reform is considered as a partial phenomenon. In this regard, the Yukos affair may suggest a partiality

The Russian government has aimed for the American model (mixed with the German model) with regard to the legal system, and with regard to social aspects, it has aimed for the European model. However, the corporate institutions cannot be completely replaced by the imported institutions. Rather, in the Putin period, the Russian peculiarity has been stressed (Mau, 2005, p. 8). The Russian stakeholders have adapted the imported institutions after their own style. Thus, the uniqueness of Russia and the interests of stakeholders are strongly reflected in the actual governance. Russian corporate governance has been strongly influenced by the privatization process, personal networks and the government, and in that context, we can observe that corporate governance has been fluctuating under the Russian transformation. As long as this uniqueness is a constraining factor on the development of the Russian economy, reforms are strongly sought. However, the reforms thus far still remain insufficient.

Notes

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² Guriev, Lazareva, Rachinsky and Tsoukhlo (2002) question, 'why is corporate governance an issue in Russia now?', and assert that although the Russian economy has grown by 20% from 1999 to 2001, the restraining factors of economic growth continue to be the problems of the expansion of investment and money flow, which in turn, render Russian corporate governance as the deciding issue that will allow a sustainable economy to take root in Russia.

³ The term 'harmonization' or 'harmonizing' is often used as a measure of the EU integration, which implies mutual approval of institutions and 'an effort to avoid the standard model than to further it'

(Hansmann and Kraakman, 2004, p. 62).

⁴ Limited companies can be established as major Russian incorporated companies by individuals, juridical persons or state organizations. The Law on Limited Company took effect on 1 March 1998. In many cases, limited companies frequently establish small to medium companies and subsidiaries, and their functions closely resemble those of closed JSCs. Limited companies do not have restrictions such as those in the case of JSCs (compulsory reserve funds, etc.), and they do not receive special tax benefits. On the other hand, limited companies have greater discretion for establishing management organizations. However, because limited companies must pay the participants their shares upon the investors' request, parent companies always have the potential risk of losing their capital. The minimum capital of limited companies is 100 times that of the official minimum monthly wage, and if net assets become less than the minimum capital, it is liquidated. Many small to medium companies comprise enterprise activities of individuals. In this case, individuals who do not comprise the juridical persons are registered by the state as entrepreneurs. This enables individuals to legally undertake enterprise activities and the Civil Code is applied. Entrepreneurs of enterprise activities that do not comprise the juridical person (PBOIuL) can hire employees, and in reality, many small shops voluntarily use this system.

⁵ The government draft is referred to as the Mostovoi P. draft, which implies that it was prepared by the State Committee for Management of Property. The government draft is a combination of the American and German models.

⁶ This draft was supported by the Federal Commission of Securities Markets (hereinafter FCSM) and was initiated by the Moscow Social Committee for Shareholders' Rights, with participation from American lawyers. The deputies' draft regulates more generally the shareholders' general meeting. It does not require the shareholders' discretion and it doubts whether large shareholders do not desire the implementation of interest protection mechanism for small shareholders. This draft protects the shareholders' rights. It has liberal characteristics such as no limitation on the amount of capital increase and promotes supporting the 'new board members'.

⁷ Leaders of large companies that have been privatized, participated in this draft. It does not limit the number of shareholders of the closed JSCs.

⁸ At the beginning of November 2004, 3.49 million commercial organizations were registered, of which 456,300 were JSCs.

⁹ The shareholders' general meeting is held annually. Since the fiscal year ends on 31 December, the meeting is held between the beginning of March and the end of June (most are held in April and May due to the tax payment period). In addition, a special shareholders' meeting is held upon request by the board of directors/supervisory board and shareholders who own more than 10% shares. In reality, the general meeting cannot be held without approval from the board of directors (Kleiner, G., *Nezavisimaya*, 8 May 2001).

¹⁰ The number of directors is 7 or more if the number of shareholders exceeds 1,000, and 9 or more

are elected if the number of shareholders exceeds 10,000. However, in 2004, amendments to the Law set the minimum number of directors at 5, regardless of the number of shareholders, and mandated that the election of board members must take place only through cumulative voting. Any shareholder who owns at least 2% of voting shares has the right to propose candidates (*Russian Business Watch*, Vol. 13, No. 1, January-March 2005, pp. 22-23).

¹¹ The cumulative voting system is used to elect board members for companies with over 1,000 employees and for other companies, the system of direct votes, which are allotted in accordance with number of shares, is used.

¹² Apart from full ownership (100%), perfect control is regarded as a case wherein ownership exceeds 75%. The decision-making power with respect to the most important issues, such as amendment of the articles, liquidation and reorganization belongs to the owners. Moreover, 51% or more ownership can secure effective control, and the owners can influence the election of directors and 'major transactions'. Generally, an amount of 51% or more is required for the 'control shares'. The 'block shares' or the 'sub-control shares' (25% or more) are those by which owners can prevent undesirable decisions of the general shareholders' meeting. Moreover, 20% or more implies that the company is subordinate and responsible for disclosure of the official date. The smallest influence is 10% or more whereby the temporary shareholders' meetings can be summoned.

¹³ At the end of 2004, there were 12 groups including Gazprom, Lukoil, Alfa, Milhouse Capital, Tatnefti, MDM, Systema and others. These groups have functioned as investment funds (Pappe, Ia., *Ekspert*, No. 12, 28 March-3 April 2005, pp. 26-31).

¹⁴ The oil company, Yukos, can be cited as an example. Yukos was located at the centre of the Menatep group, which was led by Mr. Khodorkovsky. Yuko's shares were held through the subsidiaries, grandchild companies and the associated companies that were located offshore. Although the influence of the Menatep group was strong, Mr. Khodorkovsky and his individual networks were stronger.

¹⁵ Although the influence of the state on non-state JSCs is restricted in the investigation of the national-defense companies, the influence of a crime organization is large. Moreover, the most negative results of privatization include the loss of social infrastructure (housing, kindergarten, sports facilities, etc.) offered by the companies and the relatively high level of employee dissatisfaction.

¹⁶ The most influential body on wages decision is the board of directors, followed by the shareholders.

¹⁷ Through a comparison with the Russian model, this paper addresses three typical corporate models. Pryor (2005) divides corporate models into four models—Anglo-Saxon plus, Nordic Economic System, Western Economic System and South European Economic System—based on the role of the government and the institutions. Amable (2005) divides capitalism into the five types on the basis of competition, labour relations, the financial sector, social protection and education—market capitalism, socio-democratic economies, Asian capitalism, European continental capitalism and

Mediterranean capitalism.

¹⁸ In the German reform, the enforcement of management by the board of directors becomes strong, while the supervisory function of the board of auditors is clearly separated (*Nihonkeizaishibun*, 17 June 2003).

¹⁹ Although some big businesses adopted the American management model, approximately 60% of the large firms have preserved the traditional model (*Nihonkeizaishinbun*, 6 January 2003). On 29 June 2005, the new corporate law was adopted, and the enterprises groups could be easily reorganized.

²⁰ Yukos positively influenced political affairs. It was estimated that Yukos paid between 270-350 million dollars for lobbying and sent 130 PMs as maximum (*Profil*, 21 November 2004).

²¹ There are those who express critical views on offshore companies (*Vedomosti*, 20 December 2002) and moreover, regulations imposed on it have been tightened under the Putin Government. The central bank has revised the bank law, which prohibits offshore companies from owning more than 10% of Russian banks' shares (for the purpose of enhancing the banks' transparency). Until then, this condition had been applied only to banks seeking bank deposit guarantees, but whether it should be applied to all banks, is being deliberated. Likewise, whether the regulations should target the effectively controlling companies in addition to the nominal owners, is also being deliberated. This is particularly because offshore companies never directly own shares and comprise the chain of control through limited companies regulated by Russian domestic laws; the impact this regulation will have on offshore companies is significant (*Kommersant*, 10 December 2002; *Vedomosti*, 10 December 2002).

²² The Code of Corporate Conduct was adopted in 2001. With regard to this, a survey conducted on top managers in 100 large firms indicates that 49.5% believe that the provision of the code should be normal ordinance, and 29.5% believe it should be the law. This Code reflects not only the US system (shareholder-rights oriented) but also the German system (the OECD principles) (McCarthy and Puffer, 2004, p. 394).

²³ In the industrial branch, in the case of companies involved in electricity, fuel, chemical, nonferrous metal and steel, the share of social investment for external purposes is high (more than 40%) (*Ekonomika i Zhizn'*, No. 1, January 2005).

²⁴ In 2003, financing by shares and bonds was estimated to reach 11 billion dollars in sum total, including 3 billion dollars that had been domestically procured (*Ekspert*, No. 2, 19-25 January 2004, p. 34).

²⁵ The 2004 amendment of the Law on JSCs stipulates the source of dividends (net profit).

²⁶ M&A increased by 32% in 2004.

²⁷ These scandals include conflicts in the Vyborg cellulose and paper factory in 1999, the arrest of the managers in the petrochemical holding company 'Sibur', the subsidiary company of Gazprom and other affairs such as those involving Mr. Khodorkovsky and other entrepreneurs.

- ²⁸ The task is to lower risks such as capital dilution and pressure on shareholders.
- ²⁹ The revised version in 2001 in order to check capital dilution.
- ³⁰ These problems are common to the European company law rather than to the American tradition (Radygin, A., <http://www.iet.ru>).
- ³¹ G. Gref warns that this could be a sign of the bubble economy.
- ³² In the interview conducted on 20 February 2004, it was emphasized that although the influence of outsiders in the markets has been strengthened, and that of the holding companies and the regional governments stabilized, with respect to ownership and control of firms, responsible management agencies have not been established.
- ³³ The Russian banking sector displays features that are similar to those in other petrostates, i.e. informal pocket banks with unidentified shareholders and state giants like Sberbank (Gnezditskaia, 2005, p. 476).

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