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Research Presentation

CORPORATE GOVERNANCE IN RUSSIA: ASSESSMENT OF CONDITIONS AND DIRECTIONS FOR THE FUTURE

Prepared for:

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METHODOLOGY

- Series of eighteen in-depth interviews with enterprise managers and directors of voucher investment funds:
  - Moscow: five enterprises
    seven funds
  - St. Petersburg: two enterprises
    four funds
- Six focus groups with shareholders:
  - Moscow: two groups employee shareholders
    two groups outside shareholders and fund investors
  - Ekaterinburg: one group employee shareholders
    one group outside shareholders and fund investors
- We have also included selected comments from two seminars held during the St. Petersburg: the shares seminar, which attracted approximately 1000 members of the general public and the investment seminar, which attracted approximately 125 enterprise managers.

CONTEXT: DEFINING CORPORATE GOVERNANCE IN RUSSIA

The term "corporate governance" is broad, and can (depending on who is talking) encompass such diverse ideas as:

- Establishing functioning share registries to allow for shares to be transferred between buyers and sellers.
- Instituting standards for shareholder participation (one share one vote, use of proxy, secret ballots);
- Establishment of appropriate independent checks and balances on management (independent auditors, independent members of the board);
- Disclosure of appropriate levels of financial and planning information to relevant parties;
- Meeting responsibility to shareholders (providing a return on investment, stewardship of company assets);
- Good management practices (restructuring bloated, non-competitive enterprises, profitable operation of the business, responsible business conduct, appropriate reinvestment of profits in capital improvements and in research and development);
- Or, at the most extreme, forcing replacement and/or transformation of "old-style" enterprise managers.

RESEARCH FINDINGS

I. COMMON THEMES

II. ROLES AND RELATIONSHIPS AMONG THE PLAYERS

III. RESPONSE TO SPECIFIC PRACTICES

COMMON THEMES

- Confusion and uncertainty characterize the environment within which corporate governance policies are evolving– within the context of rapid change all parties are struggling to maintain or establish control.

- Existing laws are deficient. Even these are not enforced.

- All outside shareholders voice frustration with the lack of information available to them. The information gap is felt on two levels: lack of financial information necessary to make intelligent investment decisions and lack of information on how shareholders can exercise their rights.

- To a large extent, the annual meeting has become the exclusive focus for expectations for shareholder participation in enterprises. Few other possible forums and methods for insuring management accountability to shareholders are known at this point.

- The common shareholder has focused his expectations for return on investment exclusively on dividends. Funds and enterprises both fear that shareholders hold unrealistic expectations for dividends.

CHANGE AND THE STRUGGLE FOR CONTROL

The environment within which managers function has changed radically (which they may or may not recognize and cope with):

> *"For state enterprise managers, the whole thing [privatization] happened in an instant, and they understood only one thing: that they had to select a privatization plan at once and prevent an outside buyout."* -- enterprise manager (Moscow, "new style")

> *"Enterprise managers are not coping with their new responsibilities -- they know manufacturing but have no experience with direct sales, supply or financing. Only two or three of the thirty mass-market manufacturers our fund has invested in are interested in developing sales."* -- investment fund (Moscow, young)

CHANGE AND THE STRUGGLE FOR CONTROL: MANAGEMENT

The power and autonomy of managers within their enterprises has so far remained largely unchallenged by the changes and may, in fact, have been reinforced:

> *"Directors have a Soviet mindset. As they see it, they were, are, and will continue to be the heads of their enterprises."* -- investment fund (Moscow, more mature than average) [NB: echoes Soviet slogan: Lenin lived, lives and will live]

> *"Now we are freed of bureaucratic control. All through my career I've had to fight with bureaucrats. 90% of them had never worked at an enterprise and the rest never worked in any real capacity. Bureaucrats are only concerned that nothing bad happens that will reflect on them. So what do they do? They issue prohibition after prohibition after prohibition, so you can't do anything at all."* -- enterprise manager (Moscow, "new style")

> *"In the past, the director had to answer to the ministry, but he was treated like a god in his own factory. As ministries dissolved and lost authority, the directors got complete autonomy and discovered they liked it. Now they don't want to give any of that up."* -- investment fund (Moscow, young)

CHANGE AND THE STRUGGLE FOR CONTROL: SHAREHOLDERS

The role of investors, shareholders, etc. is ill-defined with managers seeing little value in having shareholders who are not really investors (since vouchers do not bring anything to enterprises):

> *"It is too early to say, from my own experience, what the roles of shareholder, board and management will be."* -- enterprise manager (Moscow)

> *"Inside and outside shareholders should enjoy equal rights. But there is some difference between the notions of an investor and of a shareholder. The state issued vouchers, but it did not give anything to enterprises. There are no investors as such. Capital is created as a result of redistribution of vouchers that are no more than sheets of paper."* -- enterprise manager (St. Petersburg)

> *"Big investors can play a role only as a long-term partner. I'm not interested in small investors -- Why do I need a cashier in some shop [as a shareholder]?"* -- enterprise manager (Moscow, "old style")

CHANGE AND THE STRUGGLE FOR CONTROL: ANTAGONISM

Both managers and VIF's tend to perceive their conflict as a zero-sum battle for control of the enterprise. Neither is yet looking at the shareholder-manager relationship in terms of *accountability.*

Many VIF's see the only way of insuring management accountability to their interests as taking outright control of enterprises.

Enterprise managers do not see the possibility of maintaining control by actively demonstrating their accountability to shareholder interests.

Adversarial language is common:

> *"Investors' activity is aimed at getting control over enterprises through accumulating shares"*-- VIF fund manager (older, St. Petersburg)

> *"The most important issue for management in these new conditions is retaining control."* -- enterprise manager (Moscow, "old style")

> *"Directors are just office managers. They have no understanding of marketing or management."*-- investment fund (Moscow, more mature than average)

> *"It's easier to run a company without annual meetings, with only a general director who makes all the decisions. If the shareholders make a wrong decision, I'll abide by it -- but when things go wrong, I'll let them know it's because of them"* -- enterprise manager (Moscow, "old style")

CHANGE AND THE STRUGGLE FOR CONTROL: GOVERNMENT

Enterprises and fund managers share a common distrust of government and a sense that they are at the mercy of politically motivated decisions which do not serve their interests:

> *"The taxes make enterprises feel like bears rounded up by hunting dogs -- sometimes one has to pay 91 kopecks in taxes for one ruble of profit earned."*-- VIF fund manager (older, St. Petersburg)

> *The problem is that, in the government, theoreticians, who have never made money write the investment laws. We have only macro-economists working in the government. They don't understand the micro level. They don't understand you can't have the macro without the micro. (Investment Fund)*

> *Option 2 may have made sense politically, but it was bad from a practical standpoint. Giving the employees 51% of the shares just creates a new form of kolholz (Moscow fund, new style)*

DEFICIENT LAWS AND ENFORCEMENT

It is generally felt that existing regulations regarding shareholder rights and corporate governance norms are not enforced:

> *"On the surface, legislation is adhered to, but in reality, they make trouble if the fund management hurts big bosses."*-- investment fund (St. Petersburg)

> *"The law contradicts itself. In one place, it says that if a shareholder can't come to the annual meeting, he is obligated to give his vote to the board. In another place, it says that his proxy has to be notarized."*-- investment fund (Moscow, more mature than average)

> *"At the beginning, our fund tried complaining to GKI, but we never got an answer. The letters reach the middle level of GKI and die there."* -- investment fund (Moscow, more mature than average)

> *"Action is taken in only 50% of rights violations in newly privatized companies."* -- investment fund (Moscow, young)

LACK OF INVESTMENT INFORMATION AMONG FUNDS

Investment funds universally express frustration with their inability to get necessary information:

> *"I need to see the internal balance sheets and bank statements to know whether or not a company is doing a lot of business at inflated prices with, for example, a company run by the director's wife."* -- investment fund (Moscow, more mature than average)

> *"Five of the thirty companies we have invested in now provide good information -- and that was only after we convinced management that this was necessary."* -- investment fund (Moscow, young)

> *"Companies only pay attention to big outside investors. Our fund has been waiting 6 months for share registration in a company where we are one of the five largest shareholders (including management, which owns 5-10%). The director won't even speak to us."* -- investment fund (Moscow, young)

LACK OF INVESTMENT INFORMATION AMONG SHAREHOLDERS

Focus groups and the St. Petersburg shares seminar questions found that individuals are becoming aware that they lack basic information needed to make intelligent investment decisions. Specifically, individuals complain they lack:

- information on financial prospects of firms coming up for auction
- information on how well privatized enterprises have performed since privatization and their prospects for the future
- information on VIF performance

Individual outside shareholders and voucher holders are uncertain who should give them this information.

Employee shareholders receive some information from management, but usually it is not qualitatively different from the general information on "how the business is doing" that was publicized in employee meetings prior to privatization.

> *Are there shareholders who have received dividends on their vouchers. Is output increasing at corporatized enterprises? Enough of the ABC's.* (Written question submitted at St. Petersburg shares seminar)

> *Where can I receive some information on the "risk" department of the Generalny VIF?* (Written question submitted at St. Petersburg shares seminar)

LACK OF INVESTMENT INFORMATION AMONG SHAREHOLDERS

VIF's have the most direct contact with ordinary investors and they evaluate the basic level of information of the average investor as low. VIF's appear to take a reactive role vis a vis the education of investors – responding to questions (some of which they find frustrating) and giving enough information to appease shareholders:

> *"The average shareholder knows very little. Only 1 in 10 has any idea of what a dividend is. Popular knowledge about these issues is very low, and nobody reads books."* -- investment fund (St. Petersburg)

> *"Our fund's shareholders don't understand that the share value can be important. Our fund can't pay a dividend this year so we're trying to increase its share value by working with the market maker."* -- investment fund (Moscow, more mature than average)

> *"The average investor can't understand the fund's policy -- for the average investor, investment funds are like Martians who landed a year ago."* -- investment fund (Moscow, young)

> *"We tell our investors that investments are based on professional analysis. Most don't know enough to ask about the fund's management and policy."* -- investment fund (Moscow, young)

LACK OF INFORMATION ON HOW TO EXERCISE SHAREHOLDER RIGHTS

Focus groups found that individual shareholders do understand some of the basics of share ownership. The basics as described by participants in focus groups:

- A shareholder owns a part of the corporate property in accordance with the number of shares and has the right for social benefits, receiving dividends, and information on the enterprise's performance.
- The right to participate in the management of the enterprise was believed to be self-evident.
- Shareholder meetings were reported to be the main way of making their views known.

LACK OF INFORMATION ON HOW TO EXERCISE SHAREHOLDER RIGHTS

While some shareholders seem to understand basic principals, they are frustrated by a lack of information as to how they can actually exercise their ownership rights.

> *"How can you force a company to hire an independent auditor if they don't want to do it?"* Question submitted to St. Petersburg shares seminar.

> *"The director general of an AO has been elected for a five year term, as stipulated in rules which he drew up himself. Is this legal? If not, how can you stop it?"* -- Question submitted to St. Petersburg shares seminar.

> *"Are there any official organizations where we can get specific legal advice?"* -- Question submitted to St. Petersburg shares seminar.

EXPECTATIONS FOR DIVIDENDS

Unrealistic expectations for dividends abound:

> *"Passions around voucher have given rise to expectations of unrealistic profits"* -- VIF fund manager (older, St. Petersburg)

> *"Shareholders only ask where their shares are, what the dividend will be, and when the shareholder meeting will be."* -- enterprise manager (Moscow, "new style")

> *"50% of investors expect dividends to be an income source. Most expect unrealistic dividends -- and soon. In fact, the fund will probably only pay the first dividends in three years."* -- investment fund (Moscow, young)

SHARES AND DIVIDENDS: JUST ANOTHER SOCIAL BENEFIT?

In the employee and individual focus groups, social benefits and dividends are spoken about as equivalent concepts.

Responses indicate a lack of knowledge of the potential variability of dividends as enterprises go about restructuring themselves. Respondents also lack knowledge of the basic risks associated with any equity investment.

- No one in the investor focus groups voiced an interest to sell their shares, "preferring instead a small but steady income."

"Shareholders all expect dividends and see them as a stable income. No one wants to sell -- they would lose their income source." -- enterprise manager (Moscow)

EXPECTATIONS FOR DIVIDENDS

Fund advertising and political claims have helped to drive expectations:

> *"VIF advertising has led to unrealistic expectations among investors -- specifically an ad in which a person exchanges a voucher for a share and immediately starts getting dividends."* -- investment fund (Moscow, young)

> *"The average investor expects too much. This is a general problem. Their views are formed by popular information , for example, by what politicians say, and investors' unrealistic expectations can have dangerous political consequences."* -- investment fund (Moscow, "shady") [NB: the advertising of this fund is widely quoted by other fund managers as an example of what generates unrealistic expectations]

ROLES AND RELATIONSHIPS AMONG THE PLAYERS

- External shareholders of any kind lack legitimacy among managers and workers.
- Relationships between investors, funds and enterprises are strained
- Funds have potential to fulfill important role, but must mature themselves in order to meet the challenge
- Employee shareholders could play a "swing voter" role between funds and management, but at present are unlikely to act independently from management due to a variety of factors.

INVESTORS, FUNDS , AND ENTERPRISES

Anxiety on the part of enterprises concerning the role of investors is widespread -- interests of the various parties are perceived as somewhat adversarial:

> *"There is a tendency to high aggressiveness, when they (investors) strive by any means to acquire shares or to form of coalitions."* -- enterprise manager (St. Petersburg)

> *"The board's role is not to throw a wrench in the works, not to interfere. I want to improve service-- those who want high dividends would threaten that."* -- enterprise manager (Moscow)

> *"Investors should take part in almost all decisions, but the influence should depend on the size of the holding, and only so long as the investors agree with me."* -- enterprise manager (Moscow)

> *"I hope the director will maintain control so that we can maintain Krasny Oktyabr as a chocolate factory. Our biggest worry is that an investor will buy out the company just for its real estate, to build a hotel or offices."* -- enterprise manager (Moscow, "old style")

INVESTORS, FUNDS , AND ENTERPRISES

Enterprises are particularly uncomfortable with funds:

> *"VIF's are speculative organizations -- It would be better for an enterprise if it were bought by a professional ship-building company."* -- enterprise manager (St. Petersburg)

> *"All enterprises and state institutions consider funds as fat cats -- fattening on vouchers -- though it's so far from reality"*-- VIF fund manager (older, St. Petersburg)

FUNDS, ENTERPRISES, AND EMPLOYEES: CONFLICTING INTERESTS

Underlying these perceptions are real conflicts of interest between the parties involved. In theory, what is best for the development of an enterprise will be best for its investors, however:

- Employee shareholders can benefit from salary increases; outside investors only from dividends;
- Employee shareholders place maintaining jobs and social benefits as their top priorities.
- VIF short-term profits are dependent to varying degrees on enterprises declaring a dividends. (Many VIF's have other sources for short-term cash flow.)
- Often major investments are needed to adapt enterprises to free market conditions – arguing for re-investment of profits;
- Enterprise managers (faced with demands for re-investment, salary increases and dividends) are motivated primarily by the desire to maintain maximum control of their enterprise.

FUNDS: POTENTIAL ROLES

In spite of these conflicts, potentially constructive roles for funds are beginning to emerge (even if met with resistance). These include acting as financial advisors to companies and partnering to offer additional share issues (a major concern of all enterprises):

> *"The task of our partners from financial circles is to bring the enterprise management to life"* -- VIF fund manager (older, St. Petersburg)

> *"I see our role [VIF] as solving enterprise financial problems: how to issue additional shares, tax advice, etc."* -- investment fund (Moscow, young)

> *"Many directors feel VIF's are not real investors because they bring no capital -- It's rare that an intelligent one sees that VIF's can help resolve a company's financial problems."* -- investment fund (Moscow, young)

> *"The enterprises reject our ideas (for instance connected with registry of shares). They keep their accountancy away from us."*-- VIF fund manager (older, St. Petersburg)

Example of VIF enterprise cooperation: Pervy Vaucherny and Hotel Cosmos working together to place shares on the market and handle additional share issues.

FUNDS: THE CHALLENGE TO MATURE

In spite of their promise, the funds are, by and large, run by very young and inexperienced people and face challenges in maturing. Clearly the funds have a lot to prove regarding their expertise and potential contributions before many managers will be willing to invest a great deal of energy in building relationships with fund shareholders :

> *"Some funds, notably Alpha Capital, Pervy Chekovy, Programma Privatizatsii, have investment strategies, but the majority don't. They were told to diversify so they just diversify all over the place without any plan."* -- investment fund (Moscow, more mature than average)

> *"A Kommersant reporter asked me more serious questions [about our finances] than do the VIFs. There wasn't a single call from them before the auction."* -- enterprise manager (Moscow, "new style")

> *"In many ways VIFs are a soviet-style institution which plays financial games with no assets of its own."* -- enterprise manager (Moscow, "new style")

FUNDS: THE CHALLENGE TO MATURE

Caution: the rhetoric of funds must be carefully measured against actual practices. The manager of one such fund (widely reported by respondents to have engaged in shady advertising and business practices), says all the right things, but may be thoroughly unreliable:

> *Investors should act as a stabilizing factor, as a brake on bad decisions. Our fund's role is to assist the enterprise in the transition from a command to a market economy. A fund can unite common interests, be a mediator, and provide expertise."*
>
> *"Our fund is now forming its own observer committees to monitor shareholder rights violations -- we imagine they can present findings to the press and try to call shareholder meetings."*

FUNDS: AN EMERGING POLITICAL FORCE

Funds are beginning to be seen as a potentially powerful political force by enterprise managers, the public and fund managers themselves.

> *"VIF's are already turning into a political force, with millions of shareholders and their hopes behind them."* -- enterprise manager (Moscow, "old style")

> *"You hold a position, which in its 'weight category' is also political."* -- written question submitted by audience member to VIF speaker, St. Petersburg Privatization Day Shares Seminar

> *"A congress of investment funds is being formed in our region. This will be a non-commercial association. This association will pick political candidates and provide them with financial support."* -- investment fund (St. Petersburg)

INTERNAL AND EXTERNAL SHAREHOLDERS

Many managers and most employee shareholders make a strong distinction is made between outside and inside shareholders.

Accepting the idea of accountability to outside shareholders is difficult for managers to adjust to:

> *"Workers and big shareholders can have big influence -- by working hard or otherwise assisting the firm -- but non-workers should have no influence."* -- enterprise manager (Moscow, "old style")

> *"Directors sense that they now have to deal with outsiders, not like a ministry, and they have to come to grips with this. Maybe they're not happy with it -- they have no market experience and aren't used to reacting fast to a situation. The investment funds also have problems, but at least they have a year's experience over the directors in the shares market."* -- investment fund (Moscow, young)

EMPLOYEE SHAREHOLDERS: UNRELIABLE "SWING VOTERS"

In focus groups, employee shareholders were sure that they have rights for bigger dividends than outsiders. Moreover, many of them referred to outside shareholders as 'hangers-on.' Outside shareholders were of the same opinion, although they did not call themselves 'parasites.'

Understanding the underlying distrust of "outsiders" is critical for approaching questions of the specific elements of a corporate governance program. Employee shareholders were specifically resistant to the concepts of outside directors and independent auditors.

The most crucial element in employees actually developing into swing voters is the institution of the secret ballot. VIF's uniformly believe that few employees will ever risk their jobs by openly voting against management.

VIEWS OF SPECIFIC GOVERNANCE PRACTICES: CONTROL VS. SELF INTEREST

Funds generally voice strong support for most Western governance practices.

Managers responses response to specific elements of Western corporate practice are varied. Responses appear to be driven by how managers understand the relationship between the issue, their fears of losing control of their enterprise, and their other, more secondary interests.

When managers view a governance issue as an attempt by outsiders to gain control, they automatically resist it. Some managers, however, can view some issues as not directly related to the struggle for control.

VIEWS OF SPECIFIC GOVERNANCE PRACTICES: CONTROL VS. SELF INTEREST

When they can detach an issue from the control struggle and evaluate it in terms of self interest, they can be supportive of Western practices. Issues which were more likely to be accepted on this basis:

- Independent registry of shares.
- Independent auditors. are widely accepted.
- Financial disclosure.

Caveat: It sometimes appears that those practices which meet with wide acceptance are those which people believe that they can manipulate to their own advantage. It may be necessary to aim first for adoption of the forms and only later to introduce the substance.

INDEPENDENT AUDITORS

Independent auditors seen as necessary by all fund managers, but also by many of the enterprise managers.

> *"An independent auditor is important for an enterprise. He can help to point out where we're losing money and where we're doing well. We got one and it opened our eyes. It should be mandatory."* -- enterprise manager (Moscow, "new style")

Some people find the idea appealing because they see ways that it can be turned to their advantage:

> *"An independent auditor is an objective necessity. An auditor is of importance to the top administration, which must have the possibility to 'sic' an auditor on this or that subdivision"* -- enterprise manager (St. Petersburg)

> *"It's Western standard to have an auditing company approve your books. Then if the tax inspectorate finds faults, the auditor takes responsibility."* -- enterprise manager (Moscow, "old style")

INDEPENDENT AUDITORS

Competent auditors are in short supply, however, and the process can be blatantly manipulated:

> *"An auditor can point out things we don't see. Unfortunately there are very few professional auditors. Most of them are just companies that used to be state audit commissions."* – enterprise manager (Moscow, "new style")

> *"An independent auditor wouldn't necessarily give shareholders reliable information. It's easy to find a small auditing company with a license that can be bribed to sign off on anything you want. I know how these things are done. I've been in business; I've done it myself."* – investment fund (Moscow, more mature than average)

FINANCIAL DISCLOSURE

The willingness of enterprises to provide information is clearly limited. Some managers sell their self-interest in disclosing information, but most in very minimal (and possibly manipulative) ways:

> *"As far as the necessary information is concerned, to analyze the activities it is enough to have monthly balances."* -- enterprise manager (St. Petersburg)

> *"Information will be a big problem. Big investors should receive information, but information costs money and I won't waste it. "* -- enterprise manager (Moscow, "old style")

> *"We put out a newspaper. It was set up on the initiative of the administration to educate workers -- why they should go to the shareholder meeting and how to vote in their own best interest."* -- enterprise manager (Moscow, "old style")

> *"It's not necessary to present financial results -- almost none of them understand the information anyway. There are no criminals here."* -- enterprise manager (Moscow, "old style")

Interestingly enough, however, when it comes to their own financial disclosure the managers of investment funds and the managers of enterprises (whether unrepentant old-style directors or more progressive types) all sound remarkably alike:

Enterprise Managers:

> *"We consider shareholders as colleagues, but we don't have concrete plans yet for shareholder contact."* -- enterprise manager (Moscow, "new style")

> *"Because of the large number of shareholders, we will have to print basic financials in the press, but we haven't decided what to include. For the bigger shareholders we want to send them more -- along the lines of a Western annual report, with attractive pictures ... [prompted for content:] We haven't considered the financial content yet."* -- enterprise manager (Moscow, "old style")

> *"Up until now shareholders did not ask any questions, if there are any questions, it will not be a problem to answer most of them."* -- enterprise manager (St. Petersburg)

> *"Shareholders get all the information they need from the company. There are no secrets. We have a special department to provide information, but I don't know what is asked. They receive everything they are entitled to by law."* -- enterprise manager (Moscow)

FINANCIAL DISCLOSURE

Funds:

"Our fund's shareholders request no information, although all the information provided by GKI is available to them for inspection." -- investment fund (Moscow, young)

"The annual meeting mobilizes shareholders somehow, but for a fund annual meetings are a great financial and logistical burden."-- VIF fund manager (older, St. Petersburg)

INDEPENDENT REGISTRY OF SHARES

The lack of functioning registries is a frustration for funds. This issue is seen a huge obstacle to the emergence of functioning stock markets.

Some enterprises view the idea of an independent registry as completely non-threatening and a simple practical move; others see it as a control issue:

> *"The common delay in processing share transfers is a problem for us. We often want to resell shares bought at auction and need to know the largest shareholders to do so -- we often have to spy to get this information."* -- investment fund (Moscow, young)

> *"When a shareholder wants to buy or sell he's told that the woman who handles registry is on vacation, The woman also disappears before shareholder meetings."* -- investment fund (Moscow, young)

> *"We hired a depository because it's too hard and time-consuming to keep the records in-house."* -- enterprise manager (Moscow, "new style")

> *"Depository is a good arrangement because the depository company specializes in stocks, knows trading and has computers and specialists. We added everything up and decided it would be more expensive to set up our own shares department."* -- enterprise manager (Moscow, "new style")

> *"It is better to keep share registry in house. Otherwise, it would be possible someone could start 'machinations'."* -- enterprise manager (Moscow)

Proxy voting:

Although already practiced and widely accepted in principal, funds often report abuses. Funds do not assign encouraging the development of proxy voting a high priority because of perceived abuses (and perhaps because it would not have much effect in the short run -- most shares are held by employees or VIF's, both groups are able to attend annual meetings in person.)

Note: Proxy voting is almost always understood as the assignment of a shareholders voting rights to a representative. It is virtually never understood as it is practiced in the U.S.: a procedure by which shareholders designate their actual votes on specific issues that are defined in advance of the annual meeting.

> *"Proxy voting is important for logistical reasons -- with 200,000 shareholders we can't possibly find space for them all. Also, most investors can't understand fund policy -- I don't see how someone without a background can function at our meetings."* --Investment fund (Moscow, young)

> *"30 to 40% of shareholders will give their proxy to the general director. Most shareholders are women and they don't want to spend the whole day at a meeting. They want to wash, iron, and take care of their husband or kids."* -- Enterprise manager (Moscow, "old style")

> *"Our fund has been offered payment for assigning its proxy to another shareholder."* -- Investment fund (Moscow, young)

Secret ballot:

The secret ballot is viewed as essential by almost all funds.

But it is just as strongly opposed as irrelevant and unnecessary by most enterprises (even those who use it.) It is very difficult for managers to view the secret ballot as anything other than a control issue:

> *"The secret ballot is very important -- otherwise it is impossible to elect a new director."* -- Investment fund (Moscow, young)
>
> *"The secret ballot is crucial: employees will not risk their jobs to vote against management."* --Investment fund (Moscow)
>
> *"We almost always have a secret ballot -- but it doesn't really make a difference. You should not be afraid to speak your mind."* -- Enterprise manager (Moscow, "old style")
>
> *"The secret ballot is not necessary. You only need a secret ballot if you want to vote against me and pretend that you didn't. As for proxy voting -- every shareholder has the right to come [to the annual meeting] or to stay home."* -- Enterprise manager (Moscow, "new *(sic)* style")
>
> *"We have had no reason to use a secret ballot. Shareholders voted unanimously for me for General Director."* -- Enterprise manager (Moscow, "old style")

One share-one vote:

Several funds believe that managers can and will simply ignore this principal whenever it is to their advantage to do so. They fear that workers will automatically support management attempts to institute one share*holder* -- one vote, because of its more intuitive and democratic appeal.

> *"We tried to replace the director at one meeting, but the current director manipulated the voting -- each shareholder had one vote, not one vote per share."* -- Investment fund (Moscow, young)

> *"There is not secret a ballot -- the only thing that directors understand is a show of hands. And they won't allow one share one vote."* -- Investment fund (Moscow, more mature)

COMPOSITION OF THE BOARD OF DIRECTORS

Funds keenly feel the need to have their own person on the inside of enterprises -- in the absence of effective legal enforcement and financial disclosure, it is seen as the only way to protect their interests. Obtaining seats on boards of directors is a key goal of investment funds -- and one that they generally feel somewhat frustrated by, although some are successfully obtaining seats.

But the concept of independent board members is seen resisted both by employee shareholders and enterprise managers.

In focus groups, respondents reacted to the idea of independent board members negatively: They did not want to "let strangers in" and claimed that the board of directors must consist of "loyal people", who are directly interested in the enterprise's good performance. Employees viewed any people from outside with suspicion, as those who "*want to have a finger in another's' pie.*"

> *"The notion of an 'independent' director is contradictory -- a person from the outside is far from the business of the enterprise. The board should have one 'independent' director as an objective observer, but no more."* -- enterprise manager (St. Petersburg)

> *"It's bad to have independent board members -- they don't know anything. Property fund and local government representatives are a particular problem because they are only interested in dividends and local property taxes and rents."* -- enterprise manager (Moscow, "old style")

COMPOSITION OF THE BOARD OF DIRECTORS

One enterprise manager, however, had come to terms with his board:

> *"Right now we have a temporary board. We've had some misunderstandings because some members don't understand the hotel business. But the longer they are there the better they get."* -- enterprise manager (Moscow, "new style")

STRATEGIC IMPLICATIONS

- Given the lack of legal infrastructure and appropriate enforcement mechanisms, change in the behavior of enterprises is largely dependent on changing management attitudes.

- Defusing the conflict between funds, enterprises, and stockholders is essential if widespread adoption of more responsible corporate governance procedures is to be achieved.

- VIF's are the only viable forces for change among Russian shareholders. Because of the 10% rule, real influence depends on VIF's forming coalitions among themselves.

- VIF's and enterprise managers do share some common interests:

  -improving financial performance of enterprises
  -attracting domestic and foreign investment to viable enterprises
  -managing shareholder dividend expectations
  -cutting tax burdens on enterprises

STRATEGIC IMPLICATIONS

- Where possible, VIF coalitions should be encouraged to engage in a reasoned dialogue with enterprise managers on performance and governance issues, based on common interests rather than "rights" and control struggles.

- The first VIF coalition approach to any enterprise should be through a closed door meeting where VIF's appeal to management's self-interest. This will be easiest on the issues of auditors and registries and most difficult on secret ballot. Where partnerships emerge and succeed, they should be vigorously promoted in the media.

- VIF coalitions should reserve the right to publicly campaign on governance principals at annual meetings of recalcitrant companies. Again, chances of success will be greater when the campaign is based on principal rather than an attempt to grab control.

- Secret ballot, one-share, one-vote and other issues closely associated by management with control challenges will be extremely problematic until they are established by law. VIF coalitions should be encouraged to direct their political resources towards these issues, as well as towards establishing strong enforcement mechanisms.

STRATEGIC IMPLICATIONS

- Individual shareholders are desperate for two distinct types of information. Sustained public education efforts should be considered in both areas:

  -information necessary for making investment decisions
  -information on how to exercise the rights of share ownership

- Employee shareholders hold enormous potential power but at present are the single group most resistant to change. All public communications should address the specific concerns of this group.