SAFEGUARDING SHAREHOLDER INVESTMENTS IN RUSSIA

A Corporate Governance Perspective

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Syksy 2010

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Interview with Jon Hellevig on 4.12.2010.

ABBREVIATIONS

ABL	Aktiebolagslag (2005:551) (Sweden)
AktG	Aktiengesetz, 6.9.1965 (BGBl. I p. 1089) (Germany)
AL	The Federal Law on Accounting N 129-F3, 21.11.1996 (N 243-F3, 28.9.2010)
CC	The Civil Code of the Russian Federation Part I N 51-F3, 30.11.1994 (N 352-F3, 27.12.2009)
CL	The Federal Law on Competition and Restricting Monopolistic Activities on the Market N 948-1, 22.3.1991 (N 135-F3, 26.7.2006)
COSO	Committee of Sponsoring Organizations (UK)
EC	The European Community
FCC	Federal Commercial Court of the Russian Federation
FCSM	Federal Commission for the Securities Market
FRC	Financial Reporting Council (UK)
GmbHG	Gesetz betreffend die Gesellschaften mit beschränkter Haftung, 20.4.1892 (RGBl. p. 477) (Germany)
HE	Hallituksen esitys (Government bill, Finland)
IIA	The Institute of Internal Auditors
LA	The Federal Law on Auditing N 307-F3, 30.12.2008 (N 136-F3, 1.7.2010)
LC	Labor Code of the Russian Federation N 197-F3, 30.12.2006 (N 267-F3, 25.11.2009)
LJSC	The Federal Law on Joint Stock Companies N 208-F3, 26.12.1995 (N 352-F3, 27.12.2009)
LLLC	The Federal Law on Limited Liability Companies N 14-F3, 8.2.1998 (N 352-F3, 27.10.2009)
LSR	The Federal Law on State Registration of Legal Entities N 129-F3, 8.8.2001 (N 88 F3, 29.5.2010)
OECD	Organization for Economic Co-operation and Development
OYL	Osakeyhtiölaki (21.7.2006/624) (Finland)
Prop.	Regeringens proposition (Government bill, Sweden)
SCC	Supreme Commercial Court of the Russian Federation

1. INTRODUCTION

1.1. Background

Foreign enterprises have invested significantly into Russia in the last decade. According to data from the Bank of Russia, foreign direct investment grew to 75.5 billion U.S. dollars in 2008 – for comparison, in the early 2000's annual foreign direct investment constituted approximately 10 billion U.S. dollars.[1] Much of the foreign direct investment is directed to subsidiaries of foreign enterprises. The type and value of such investments vary, but usually comprise capital, know-how or other assets.

Under such investments the foreign enterprise, in practice, renders the investment and the assets that the investment comprises into the hands of the Russian subsidiary's management, which is expected to govern the investment and the subsidiary profitably to allow the foreign enterprise to collect a return on the investment. There is, however, a risk that the management of the Russian subsidiary considers it more beneficial – for itself – to use the subsidiary's assets in a manner contrary to the objectives and interest of the foreign investor. At its extreme, unfaithful management behavior can take form in self-dealing or other dilution of the subsidiary's assets, causing the foreign enterprise to lose the investment.

In corporate law the potential conflict of interest between the management and the shareholders that result from the separation of ownership and control is called the principal-agent problem. In a principal-agent relationship the principal engages the agent to perform a service on behalf of the principal and renders certain decision-making authority to the agent for performing the service. In this relationship the welfare of the principal depends on the actions of the agent, since the agent acts on behalf of the principal and, in the case at hand, governs the principal's assets. When applied to a company, the shareholders constitute the principal and the management the agent, since the shareholders hire the management to govern the company into which the shareholders have invested their assets. The shareholders are dependent of the management's conduct, since the shareholders' profit or return on investment depends on how successfully the management

[1] Bank of Russia 2010. de Souza 2008 p. 10. In 2009 foreign direct investment decreased to 36.8 billion U.S. dollars (Bank of Russia 2010).

conducts the company's management. Since the management may recognize other ways of maximizing its profit from the relationship, there is a risk that the management decides to act, from the perspective of the shareholders, unfaithfully, to ensure its own profit from the relationship. In addition, there is often an asymmetry of information between the shareholders and the management, since the management is engaged in the company and its activities in higher degree than the shareholders are and therefore usually has better information on the company's activities and financials than the shareholders have. This asymmetry of information facilitates opportunistic management behavior, since it is difficult for the shareholders to assure themselves that the management acts in the company's and the shareholders' interest.[2]

To improve the position of shareholders and to reduce agency costs – the costs arising from measures taken for mitigating risks related to the principal-agent problem – several Western jurisdictions have included specific fiduciary duties for the management in their company laws. This is also the case in Russia, where the Civil Code and the company laws require the management to act in the interest of the company in good faith and prudently (CC § 53.3.1, LJSC § 71.1.1, LLLC § 44.1.1). The law thus establishes a fundamental obligation for the management to act in the interest of the company (and the shareholders). The management is liable for the damage incurred by the company, if the management engages into self-dealing or causes the company a damage or loss in some other manner (LJSC § 71.2.1, LLLC § 40.2.1).[3] It is further stated in the Russian Corporate Governance Code that the management should to apply the due diligence and care that can be expected from good managers under similar circumstances.[4] The management should also ensure that the company's operations are conducted in strict compliance with the law, the charter and by-laws, as well as the company's objectives.[5]

> Fiduciary duties can also be found in the German *Aktiengesetz*, which requires an *aktiengesellshaft*'s – the German equivalent of a Russian joint stock company - management board members to act in the best interest of the company and to adopt appropriate decisions on the basis of sufficient information (AktG § 93.1). Similarly the *Gesetz betreffend die Gesellschaften mit beschränkter Haftung* states that the general director of a *Gesellschaft mit beschränkter Haftung* – the German equivalent of a Russian limited liability company – to apply the diligence of a prudent manager when attending to

[2] See Jensen & Meckling 1976 p. 5. Armour et al. 2009 pp. 35-37. Mähönen & Villa 2006 pp. 86-87.
[3] See Yudenkov 2010 pp. 77-78. Telyukina 2005 pp. 461-462. Ignatova 2006 pp. 193-194.
[4] FCSM Code Chapter 4 Section 3.1.1, paragraph. 1.
[5] FCSM Code Chapter 4 Section 3.1.3, paragraph 1.

matters related to the company (GmbHG § 43.1).[6] In the U.S. the liability of directors is considered by application of the business judgment rule. According to the rule, a director cannot be held liable for damage or loss incurred by the company, if the director 1) acted on an informed basis, 2) in good faith and 3) in the honest belief that the action was taken in the best interest of the company. The business judgment rule can only be pleaded by disinterested directors that have studied all material information reasonably available, presuming that the directors applied necessary care in the decision. When considering the necessary standard of care, the business judgment rule is not considered to cover gross negligence. The business judgment rule does also not cover situations where the directors have failed to function (Aronson v. Lewis (Del. 1984), also Brehm v. Eisner (Del. 2000)).[7] The Finnish *Osakeyhtiölaki* requires the management to act in the interest of the company with due care (OYL § 1:8).[8]

The aforementioned principal-agent problem is severer in cross-border ownership structures where the separation of ownership is sharper. The principal-agent problem may also be more immense in Russia owing to the management tradition that was formed during the Soviet era. In the Soviet Union the function of the management was essentially different from the function of Western management, since the enterprises were different types of organizations. The foundation and termination of a Soviet enterprise was decided by the state and in practice its main objective was to perform instructions and obtain recognition from superior organizations instead of making profit. Demand was determined by the state and meant that the enterprise's success or failure was not dependent on the management's efforts.[9] The State Planning Committee, *Gosplan*, imposed production targets on each enterprise and dictated what and in what amount the enterprise should produce. It also assigned resources and materials to the enterprise and distributed the manufactured products further to other domestic enterprises or for export.[10]

Managers of the Soviet enterprises had limited decision-making power. Each Soviet enterprise was ultimately subordinate to a branch ministry, an administrative body supervising the sector of the economy to which the enterprise belonged. The branch ministry controlled planning targets and managed resource availability, capital flows, research and development, product introductions and distribution of manufactured products.[11] A majority of decisions, especially the more crucial ones, were taken by the

[6] See du Plessis & Saenger 2007 pp. 58-59.
[7] In Russia the Supreme Commercial Court has ruled that the general director cannot be held liable for damage incurred by the company, if the general director acted within the framework of reasonable business risk. The burden of proof is with the shareholders (SAC N. 871/07).
[8] See Mähönen & Villa 2006a pp. 114-115, 120-122.
[9] See Kornai 1992 pp. 262-265.
[10] See Adachi 2005 pp. 9-10.
[11] See Adachi 2005 p. 10.

ministry, not by the manager of the enterprise.[12] The managers of a Soviet enterprise thus had narrower authorities and less such responsibilities that normally are connected to the management in Western enterprises. A management position however entailed significant benefits for the manager.

Upon appointment the management – the management was appointed by the relevant ministry and usually included the general director, the chief engineer, the chief accountant, the director of technology and the director of personnel – became part of the country's economic elite with considerably higher salaries than the rest of the population. The appointment also entailed lucrative benefits, inaccessible to the rest of the population. The management was allowed to shop at privileged stores with rare products and cheaper prices, and avoided the long lines and other logistical difficulties encountered by ordinary citizens in the Soviet Union. Moreover, the management and members of their families had access to the best medical services available, and were provided the best accommodation and other utilities at no cost, as well as allotments of foreign currency for traveling abroad.[13]

In addition to the above-referenced privileges, managers had a number of accepted, but informal benefits that entailed the use of company assets for personal gain. Managers were, for example, entitled to renovate their apartments or summer cottages by using the company's employees and materials. Sometimes company cars were assigned to family members. Also relations with other companies were exploited. For example, a company could supply goods or a service to another enterprise for a lower price or for free. The favor would then be returned to the manager of the supplying company on a personal level. However, managers could not exploit their positions excessively because the performance targets established by the *Gosplan* had to be met. It was also important that the general public did not become irritated about the management's behavior in a manner that would generate complaints to party and government officials.[14] A management position thus entailed significant benefits that functioned as an incentive for the management to work toward the objectives set forth by the State Planning Committee.

[12] See Kornai 1992 p. 271.
[13] See Brown, Jr &Shkurupiy 2000 pp. 643-644.
[14] See Brown, Jr &Shkurupiy 2000 pp. 644-646.

On the other hand, the management was strictly supervised, which limited its possibilities to abuse the management position. Oversight of Soviet enterprises was three-fold and performed by the relevant ministry, the KGB and the Communist Party. As stated above, the relevant ministries controlled most of the enterprise's activities, including supplies, distribution of products, financing, and other such issues. The branch ministry also had the authority to dismiss a manager that failed to obey its directives and orders. As a rule, meeting the objectives set by the *Gosplan* was considered good management, while a failure thereof could result in the management's dismissal. Since the enterprises were not always granted the raw materials and other resources that they needed for being able to meet their objectives, a barter economy where managers acquired missing resources developed. The Ministry of Finance and its revision commission (the *Kontrolno-Revisionnoe Upravlenie*) provided oversight of companies through inspection of their financial activity and transactions. Miscalculations or mistakes could be regarded as theft or waste of resources, for which the management could be dismissed.[15]

The KGB, on the other hand, controlled Soviet enterprises through the First Directorate. The official task of the First Directorate was to secure state secrets, which included control over mail dispatches and other dispatches of sensitive documents, as well as supervision of personnel records and employees. KGB officers collected any information on respective companies, including personal information on its management and employees, enabling it to control the company and collect information outside of the management's control. KGB was thus generally considered to have the most accurate information on Soviet enterprises. Due to that the KGB was subordinated to the Central Committee of the Communist Party and had connections directly to the Politburo, its supervision was particularly feared. KGB also supervised foreign trade by including representatives on international business and trade delegations.[16]

In addition to the relevant ministry and the KGB, supervision of Soviet enterprises was conducted by the Communist Party. The companies had party committees or bureaus, which secretaries in key enterprises were subordinate directly to the Central Committee of the Communist Party. The party committee was entitled to access management reports and was vested with the authority to give recommendations and order the management to

[15] See Brown, Jr & Shkurupiy 2000 pp. 646-647.
[16] See Brown, Jr & Shkurupiy 2000 pp. 648-649.

undertake actions for improving the enterprise's performance. The party secretary could further interfere with management decisions by making a complaint to the party committee. Such complaint could lead to disapproval of a particular manager within the party, which ultimately could lead to expulsion from the party. Expulsion from the party in turn meant immediate dismissal from the management position and loss of social status, including all the benefits that the management position entailed.[17]

A management position in the Soviet Union was thus a position with significant benefits. However, despite that managers were allowed to use the enterprises property for personal purposes, strict supervision of the management was performed by various government authorities, which limited the management's possibilities to exploit its position too excessively. The disestablishment of the Soviet Union and the introduction of a market economy entailed a change in several aspects, since benefits of management positions became less extensive and less lucrative as the management was no longer allowed to exploit the enterprise's assets for private purposes, effective government control vanished in the form it was performed during the Soviet era and the authorities and responsibilities of the management became more extensive as the responsibilities of the ministries and other government authorities were assigned to the management.

In relation to abusive management behavior and self-dealing the removal of the control system was probably the most significant change that took place in connection with the introduction of the market economy in Russia. In Western market economies shareholders can revert to state courts if their rights are violated or in case of managerial misconduct. However, when the Soviet Union was dissolved, there were in practice no courts that would have had the experience to resolve matters related to Western-type companies, since there were no similar companies in the Soviet Union. Also, a modern independent judicial system, which had been created only in 1864, did not due to various political reasons gain support or any high degree of institutionalization before the Bolshevik revolution in 1917, after which the newly introduced judicial system was abolished.[18]

> It may also be mentioned that courts had traditionally been subordinate to the Russian Emperor. For example, despite that Peter the Great attempted to westernize the legal tradition already in the 18th century, he was known to distrust judges and lawyers and did

[17] See Brown, Jr & Shkurupiy 2000 pp. 649-650.
[18] Smith 1996 pp. 18, 25.

> not accede to restrictions to his powers. He authorized the Senate, a judicial and advisory body which members comprised of the members of the nobility, to control the functioning of the judiciary and punish "unrighteous judges".[19]

After the revolution of 1917 a new judicial system including people's courts and revolutionary tribunals was established. The revolutionary tribunals, which were planned as simple, informal courts open to mass participation, constituted the primary tool for political repression in defense of the revolutionary order, handling cases where class enemies had committed hostile acts against the new regime. The people's courts had jurisdiction in minor cases and handled mainly cases related to family matters, housing and labor law, and other matters of relatively low economic value. The jurisdiction of the state arbitration courts, or Arbitrage Courts[20], that were founded during the New Economic Policy handled disputes between state enterprises and institutions.[21] During the Soviet era the judicial system and the law lacked autonomy. The Communist Party could interfere in any legal dispute and dictate the result. Hence, the general public commonly perceived the law as an instrument of the Communist Party to enforce its political goals.[22]

The brief account of the history of the Russian judicial system illustrates the background against which Western-model courts were established after the Soviet Union. Owing to the undeveloped and inexperienced judicial system and the lack of other necessary institutions and corporate traditions, the Law on Joint Stock Companies of 1995 was designed to be self-enforcing, i.e. to rely on the judicial system and other institutions as little as possible until they developed in the necessary extent.[23] As a self-enforcing law, the law attempts to empower the company's participants, such as shareholders and the board of directors, to enforce its provisions, rather than relying on indirect "participants", such as courts. The main objective of the law was to grant stronger protection for external (minority) shareholders against insiders, to include procedural rules requiring shareholder or board approval for certain transactions to safeguard shareholder interests, to use clear rules and provisions instead of general rules that would require interpretation and to include specific written legal sanctions in the law.[24]

[19] Smith 1996 pp. 8, 17.
[20] Currently known as the Commercial Courts.
[21] Feldbrugge 1993 pp. 201, 208-209. Smith 1996 p. 29.
[22] Hendley 1997 p. 230.
[23] Black & al. 1999 pp. 20-22.
[24] Black & al. 1999 pp. 24-25. Also Black & Kraakman 1996 pp. 16-29.

> The Russian Corporate Governance Roundtable stated in 2002 in its recommendations regarding Russian corporate governance that to allow companies to function properly, highest priority should be given to strengthening the legal and regulatory framework to ensure effective implementation and enforcement of the law. It considered enforcement of provisions related to equal treatment of shareholders, expropriation of corporate assets by managers and violations of disclosure requirements to be of particular importance. To strengthen the judiciary's capacity to deal with commercial disputes, the roundtable recommended courts to be provided with the necessary resources for hiring and training judges, as well as that the salaries of judges are increased to attract experienced and educated professionals. Training especially in company law, securities law and bankruptcy law should be provided, including training in basic business concepts, since lack of exposure to regular business practices was considered to be able to result in extremely literal application of the law.[25]

Since the Law on Joint Stock Companies was designed to be self-enforcing, it could be expected to provide the shareholders with comprehensive tools to tackle the above-referenced principal-agent problem. It thus contains provisions on major transactions and related party transactions requiring shareholder or board approval depending on the value of the transaction. It also establishes an obligation for the management to act in the interest of the company, provides for liability of damage caused to the company by misconduct and grants shareholders access to certain company documents. On the other hand, shareholder authorities are restricted and the management is not required to provide reports on the company's operations to the shareholders, save for the annual reports. To improve their position in relation to the management, shareholders can establish policies, processes and institutions that determine the manner in which the management shall conduct the company's management. These systems are commonly referred to as corporate governance and internal control frameworks.

> According to a definition of corporate governance produced by the UK Cadbury Committee, corporate governance is the system by which companies are directed and controlled.[26] Its purpose is, according to the UK Corporate Governance Code, to facilitate effective, entrepreneurial and prudent management that can deliver long-term success.[27] Internal control, on the other hand, can be considered a process implemented by a company's board of directors, management and other personnel to provide reasonable assurance regarding the achievement of objectives in the categories of effectiveness and efficiency of operations, including achievement of performance goals and safeguarding of assets, reliability of financial reporting, and compliance with applicable laws and regulations.[28]

[25] OECD 2002 Sections 12-13, 185-187. Also OECD 2004 p. 17.
[26] Cadbury Committee 1992 Section 2.5.
[27] FRC 2010 Section 1.2.
[28] COSO 1994 p. 3.

According to the Russian Corporate Governance Code, corporate governance practices should ensure the shareholders a real possibility to exercise their shareholder rights, provide for the equal treatment of shareholders, provide for strategic management and effective control of the management by the board, allow the management to conduct the company's day-to-day operations prudently, in good faith and solely in the interest of the company, ensure that the management reports to the board and the shareholders and provide for timely disclosure of full and accurate financial information on the company, as well as ensure efficient control over the financial and business operations of the company.[29]

By virtue of the Russian Corporate Governance Code, the principal objective of internal control is to ensure adequate protection of shareholder investments and the company's assets. To achieve this, the code recommends to ensure that an annual business plan is prepared and approved, that internal control processes are complied with, that efficient and transparent management systems are implemented, that abusive management behavior is prevented and corrected and that the financial information used and distributed by the company is accurate. The supervision of the entity's financial and business operations should be carried out by the board of directors and its audit committee, the revision commission, the internal audit service and the auditor.[30]

1.2. Objective and Scope

The main objective of this thesis is to identify the relevant corporate institutions, such as governing bodies with supervisory and control functions, and corporate governance and internal control instruments, processes and policies that a foreign shareholder can utilize in Russia to exercise control over a Russian subsidiary and its management. The authorities of the management and the shareholders are initially reviewed to clarify in which extent the management is authorized to independently dispose of the subsidiary's assets, as well as to clarify the authorities of the shareholders in relation to the management and the company. The analysis of the management's and the shareholders' authorities is followed by an analysis of the management's reporting duties and the shareholders' right to obtain information related to the company to clarify whether a severe asymmetry of information

[29] FCSM Code Chapter 1 Sections 1-5, Section 7.
[30] FCSM Code Chapter 8 Introduction.

can be expected in a Russian company. If the management's authorities are extensive in comparison to the shareholders' authorities, and especially if the asymmetry of information between the parties is severe, then more comprehensive control systems are required.

Since the board of directors is usually charged with the supervision of the management, the board's function and responsibilities in a Russian company are reviewed to analyze in what manner the shareholders could utilize the board to exercise control over a Russian subsidiary and its management. The audit committee of the board of directors is discussed separately in this connection, since it has an important function in performing, maintaining and developing internal control in the company. Further, the function of the internal audit service, which is charged with continuous internal control in the company, and the function of the revision commission, which is an internal auditor, and the role of the auditor are looked into. These institutions form a part of the corporate governance and internal control framework through which the company is governed and controlled.

To create the necessary corporate governance and internal control frameworks, these frameworks should be provided for in corporate documents. The most relevant corporate governance instruments constitute the charter and the company's by-laws (the internal documents as they are referred to in the Russian law), in which the distribution of authorities between the governing bodies, as well as their functions and responsibilities should be manifested. In addition to these instruments, executive management agreements and the business plan are taken into consideration.

The below account attempts to answer, in particular, the following questions:

1. *Does the company laws vest the management with extensive authorities to conduct the company's operations and dispose of its assets in comparison to shareholder authorities?*
2. *What types of management reporting duties does the law provide for and respectively are the shareholders entitled to request information on issues related to the company and its operations and financial standing?*

3. *Which are the governing bodies and other institutions charged with supervisory and control functions and what are their authorities and respectively duties and responsibilities?*
4. *Which instruments are of relevance for creating the necessary control systems and what is their essential content?*
5. *What kind of corporate governance and internal control frameworks does the Russian law provide for?*

I will not touch upon the risk management aspect of internal control, which indeed constitutes an essential feature of internal control. The objective of this thesis is, however, not to study how internal control processes may be used to minimize business risks, but how the shareholders can mitigate risks related to the principal-agent problem, and in particular, how abusive management and dilution of assets can be prevented. The emphasis of the thesis is on preventive control systems – it does therefore not devote to any analysis of the executive management's liability, notwithstanding that such liability is naturally provided for by the law. Only private companies with one or a few shareholders belonging to the same group are considered, i.e. subsidiaries of foreign enterprises. Also, the thesis does not attend to issues related to safeguarding shareholder interests in relation to other shareholders. Since the subject is approached from a legal point of view, the possibility to use different remuneration systems to influence the management's loyalty is not considered. Material provisions of the accounting laws and regulations are not considered, since the objective of the thesis is not to assess the accuracy or completeness of Russian accounts, but rather the rules related to disclosing the accounts and their content.

Finally, only private joint stock companies and limited liability companies are considered. The fundamental difference between these two company forms is that only joint stock companies have shares and shareholders (CC § 96.1.1, LJCS § 2.1.1). In limited liability companies the owners own a part of the company's charter capital and are called participants (CC § 87.1.1, LLLC § 2.1.1). However, in this thesis the owners of both company types are called shareholders. More detailed differences between the two company types will be accounted for in the following chapters in the extent they are relevant for the purpose of the thesis. It should be noted that in both company forms the shareholders' liability for the company's debt and other obligations is limited to the value

of their contribution to the company's charter capital (CC 1 96.1.1, CC § 87.1.1, LJSC § 2.1.2, LLLC § 2.1.1).[31]

1.3. Sources

The main statutes for the purpose of this thesis comprise the Federal Law on Joint Stock Companies and the Federal Law on Limited Liability Companies. The Civil Code[32] and certain other statutes are taken into consideration in the extent they are relevant for the subject of the thesis. The Russian Code of Corporate Governance has been studied alongside the provisions of the law and used to complement the law when such complementary provisions have been available.

Relevant court practice has been reviewed to examine how the law is implemented and construed in practice. Court practice has been studied only in the extent necessary for illustrating the application of the provisions of the law being in key position in relation to the subject of this thesis and the interpretation of which is or can be unclear or ambiguous. The purpose has thus not been to exhaustively account for related court practice. Also, only decisions of the supreme courts and the federal courts have been taken into consideration. It should be noted that the decrees issued by the supreme courts as guidance for the lower courts are of significant relevance when analyzing the application of the law. Hence, they are attended to also in this thesis.

Since the Russian law is in a constant state of change, legal literature has been used as guidance in perhaps a more restricted manner than it could have been used, for example, in a Western jurisdiction such as Finland, where the law does not change as rapidly in Russia. The doctrine, in particular the more fresh part of it, has, however, been researched and used in the extent possible to analyze the interpretation and meaning of the various legal provisions relevant for the thesis.

[31] Yudenkov 2010 pp. 111, 121. Kashanina 2010 pp. 328-329. Ignatova 2006 pp. 16-18. Similar company forms are found in Germany, where the joint stock company (the *Aktsiengesellschaft*) is a public company in which the shareholders own shares and the limited liability company (the *Gesellschaft mit beschränkter Haftung*) in which the participants own a part of the charter capital (AktG § 1.2, GmbHG § 5.2, see Beurskens & Noack 2008 pp. 1075-1077).

[32] For an account of the Civil Code's relation to other federal laws see Orlov 2010 pp. 26-28.

To illustrate differences – and also to illustrate similarities, since the Russian company laws are not very different from other company laws – in, and perhaps to suggest how some issues provided for in the company laws could be regulated differently, solutions chosen in the company laws of other countries, especially Germany, Finland and Sweden, have been researched alongside the Russian law. Here the purpose has not been to exhaustively compare the Russian company laws to the company law of any other jurisdiction. The purpose is, rather, to evaluate the Russian provisions on the basis of other company laws to see in what extent the Russian law is different from these company laws and to consider whether there could be alternative ways for regulating some of the issues that are in key position for safeguarding shareholder investments in Russia. Emphasis has been put on German company law, since the Russian company laws in some extent resemble the German company laws.

Further, to measure the Russian company laws against international standards and in certain extent to find guidance for construing the Russian company laws, the Russian law has also been studied from the perspective of international principles, such as the OECD Principles of Corporate Governance and other similar codifications of corporate governance.

2. MANAGEMENT AUTHORITIES AND INFORMATION

2.1. The Executive Management's Authorities

2.1.1. The General Director's Authorities

The executive management of a joint stock company and a limited liability company may consist of either solely a general director, or alternatively of a general director and a management board (CC § 103.3.1, LJSC § 69.1.1, CC § 91.1.2, LLLC § 32.4.1). Each company therefore must have a general director, while the management board is optional and may be established at the shareholders' or the board of directors' discretion if provided for in the charter.[33] The management can be foreign or comprise of Russian citizens. Since the board of directors is optional in all limited liability companies and in joint stock companies with less than 50 shareholders, the general director constitutes the only mandatory governing body in addition to the general meeting of shareholders (CC § 103.2.1, LJSC § 64.1.2, LLLC § 32.2.1). The management may be outsourced to a so-called management company, which replaces the general director and the management board (LJSC § 69.1.3, LLLC § 42.1.1).[34]

> A similar management structure including a voluntary board of directors and a mandatory general director is found in German limited liability companies (GmbHG § 6.1, GmbHG § 52.1). Usually, however, the management involves a mandatory board of directors and an optional general director. Also the OECD Principles of Corporate Governance are based on the principle of separation of supervision and management by means of the supervisory board performing supervision over the executive management.[35] In Finland and Sweden, for example, the board, which is an obligatory governing body, may at its discretion elect a general director (OYL § 6:20.1, ABL § 8:27.1).[36]

The general director is appointed and removed by the general meeting of shareholders, unless the charter assigns the authority to appoint and remove the general director to the board of directors (LJSC § 69.3.1, LLLC § 40.1.1).[37] The general director is prohibited from simultaneously serving as the chairman of the board of directors (LJSC § 66.2.2, LLLC § 32.2.3). The chairman of the board can thus not be appointed to the position of general director or *vice versa*.[38]

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[33] See Shitkina 2007 p. 343. Yudenkov & Mozolin 2010 p. 116, 133-134.
[34] See Shitkina 2007 pp. 330-331, 349. Yudenkov & Mozolin 2010 pp. 132-133. Rovnuy 2010 p. 295.
[35] OECD 2004 p. 58.
[36] See HE 109/2005 p. 78. Prop. 2004/05:85 p. 626.
[37] See Shitkina 2007 pp. 344 - 345.
[38] See Makarova 2005 pp. 261. Mogilevskiy 2010 p. 330.

It is essential to differentiate between the general director's authority to represent the company and the general director's authority to independently make decisions concerning the company and its activities. The latter is commonly referred to as the general director's competence. According to the law, the general director acts on behalf of the company, represents its interests and, in particular, enters into agreements on behalf of the company (LJSC § 69.2.3, LLLC § 40.3.1, item 1).[39] The general director is thus authorized to represent the company. In regards to representing the company the law grants the general director a considerably strong position, since neither the board nor the general meeting of shareholders, which are superior governing bodies in relation the general director, are granted any authorities to represent the company toward third parties under ordinary circumstances. It should be noted that the general director represents the company also in matters that do not belong to the general director's competence, only in these cases in accordance with prior shareholder or board instructions or approval.

> A similar strong position to represent the company can be found in German joint stock companies, where the management board is solely authorized to represent the company without the other governing bodies having authorities to restrict this right (AktG 78.1, AktG § 82.1).[40] In German limited liability companies restrictions to the general director's right to represent the company are not effective toward third parties (GmbHG § 37.2). In Finland and Sweden, on the other hand, the company is mainly represented by the board, while the general director has the authority to represent the company only in matters belonging to the general director's competence (OYL § 6:25.1, ABL § 8:35.1, ABL § 8:36.1).[41]

The general director's competence, in turn, comprises all matters that belong to the company's day-to-day operations, except matters that the law or the charter assigns to the competence of the general meeting of shareholders, the board of directors or the management board (CC § 103.3.1, LJSC § 69.2.1, CC § 91.1.2, LLLC § 40.3.1, item 4). The general director is thus competent to decide in any matter related to the company's day-to-day operations as long as the particular matter has not been assigned to the competence of any of the other governing bodies. The law further specifically assigns to the general director's competence the authority to choose the company's employees and

[39] See Lapteva & Zankovsky 2006 pp. 109, 121-122.
[40] See du Plessis & Saenger 2007 p. 50.
[41] See HE 109/2005 vp pp. 88-89. Mähönen & Villa 2006b pp. 177-178. Prop. 1975:103 p. 380-381. Prop. 2004/05:85 p. 629. Skog 2009 pp. 188-191. The Finnish company law provides for an administrative board, which similarly to the Russian board of directors lack authority to represent the company (OYL § 6:21.1).

issue orders and instructions to them (LJSC § 69.2.3, LLLC § 40.3.1, items 2-3).[42] The general director is also required to execute the decisions of the general meeting of shareholders and the board of directors (LJSC § 69.2.2).[43] The competence of the general director should be stated in the charter (CC § 52.2.1, CC § 98.3.2, LJSC § 11.3.1, CC § 89.3.2, LLLC § 12.2.1).[44] Provisions concerning the general director's competence are especially important in the charter if the competence of the general director has been restricted by the shareholders.

> In court practice the general director has been held competent to appoint the board of directors of a subsidiary (FCC Ural Circuit N F09-7296/08-S4). The general director should thus also be competent to directly appoint the general director of the subsidiary, unless the charter contains a provision providing for the contrary. The general director is, however, not competent to make decisions regarding acquisition or disposal of shares in subsidiaries, since these decisions belong to the competence of the board of directors.[45]

The general director shall pursue the goals and objectives that the shareholders and the board of directors establish for the company and implement the company's strategies and policies.[46] The general director should strive to ensure the company's profitability and competitiveness and a stable financial standing, as well as solicit the rights and lawful interests of the company's shareholders, and also ensure that the labor and social rights of the company's employees are protected.[47] The general director should act prudently, in good faith and in the best interest of the company and should apply the due diligence and care that can be expected from a good director under similar circumstances.[48]

In joint stock companies that lack a board of directors, the charter should set forth the company body responsible for convening the general meeting of shareholders (LJSC § 64.1.2). Usually this is the general director. In limited liability companies the general meeting of shareholders is convened by the general director (LLLC § 34.1.1, LLLC § 35.2.1). If the company has a board of directors, the responsibility to convene the general

[42] See Yudenkov & Mozolin 2010 pp. 116, 133. Also Shitkina 2007 pp. 346-347 for a practical list of issues belonging to the general director's competence.
[43] The Law on Limited Liability Companies does not provide for this particular duty. It should however follow from the general management hierarchy (see e.g. Ignatova 2006 p. 188).
[44] See Dolinskoy 2006 pp. 372-374. Ignatova 2006 pp. 70-71. Yudenkov & Mozolin 2010 pp. 76-77, 113-114, 125. Eremichev & Pavlov 2010 p. 200.
[45] See Chapter 3.1 below.
[46] FCSM Code Chapter 4 Introduction, paragraph 2.
[47] Shitkina 2007 p. 343.
[48] FSCM Code Chapter 4 Introduction, paragraph 4. FCSM Code Chapter 4 Section 3.1.1, paragraph 1.

meeting of shareholders can be assigned to the board (LLLC § 32.2.2.1).[49] The general director is further responsible for ensuring that the company's accounting and financial reporting is appropriately organized, which often entails hiring a so-called chief accountant (LJSC § 88.2.1, Law on Accounting § 6.1.1).[50]

If the company has a management board, the general director acts as its chairman (LJSC § 69.1.2, LLLC § 41.1.4). In joint stock companies where a management board is established, the general director's powers to represent the company remain the same regardless of whether a management board is established and the general director signs all documents on behalf of the company, including protocols of management board meetings, and acts on behalf of the company without power of attorney (70.2.3).[51] This is not explicitly stated in the Law on Limited Liability Companies. However, since the law does not provide for any authorities to represent the company for the management board, the management board should not be considered to have any authorities to represent the company. The shareholders could, however, for sake of clarity, include a provision in the charter to regulate this issue in limited liability companies. It is important to note that the general director is required to follow the management board's decisions in issues belonging to the management board's competence, which in practice makes the general director subordinate to the management board in such issues. This is specifically stated in the Law on Joint Stock Companies (LJSC § 70.2.3).[52]

The Russian Corporate Governance Code stipulates that the management should conduct the company's activities in accordance with a *business plan* annually approved by the board of directors. The business plan should contain basic guidelines for the day-to-day operations of the company. By setting forth appropriate objectives in the plan, the shareholders and the board of directors may use the annual business plan as a means for supervising and controlling the general director's conduct and to evaluate the management's performance.[53] To provide shareholders with direct insight in the

[49] See Shitkina 2007 pp. 319-320. *Ignatova* sees a conflict between LLLC § 34.1.1 and LLLC § 32.2.2.1 and considers that only the general director can convene the general meeting of shareholders (Ignatova 2006 p. 172).
[50] See Rozhdestvenskaya 2010 pp. 74-77.
[51] See Makarova 2005 p. 259.
[52] See Shitkina 2007 pp. 343-344.
[53] FSCM Code Chapter 3 Section 1.1, paragraph 3, Chapter 4 Section 1.2, paragraphs 1-2. See Kashanina 2010 pp. 451-456. Makarova 2005 p. 259.

company's activities, the approval of the business plan could be assigned to the annual general meeting of shareholders. The shareholders may also establish a by-law regulating the general director's activities to set forth principles, objectives, and rules that the general director shall follow, for example, a General Director Policy.[54]

> In German limited liability companies the general director – there may be one or more – is responsible for managing the company and is vested with extensive authorities allowing the general director to resolve any issue related to the company in the extent not specifically restricted by the charter or prohibited by the shareholders or the board of directors (GmbHG § 35.1, GmbHG § 37.1, GmbHG § 52.1). The general director is also responsible for arranging the company's accounting (GmbHG § 41).[55] In Finland the general director is authorized to represent the company in matters within the general director's competence (OYL § 6:25). The general director's competence comprises the company's day-to-day operations. The day-to-day operations include managing the company and supervising its organization, making agreements with suppliers and customers, recruiting personnel and executing shareholder and board decisions. As a general rule, the general director can undertake actions that do not belong to the day-to-day operations only with the board's approval. The general director shall conduct the company's day-to-day operations in accordance with the board's instructions. The instructions may be oral or written and may be general or relate to a specific matter. The general director is also responsible for organizing the company's accounting and financial management in accordance with the law (OYL § 6:17).[56] The general director has similar authorities in Sweden (ABL § 8:29, ABL § 8:36). The Swedish company law requires the board to prepare a written instruction providing for the distribution of duties and responsibilities between the general director and the board and other bodies founded by the board (ABL § 8:7).[57]

2.1.2. Restrictions to the General Director's Authorities

Restricting the general director's should be considered in relation to the authority to represent the company and in relation to restricting the general director's competence. As mentioned above, the general director is the only governing body authorized by the law to represent the company. As the law does not provide for a possibility to transfer the general director's authority to represent the company to any other governing body and as no other governing body is vested with the authority to represent the company, and in particular since the law does not provide for any particular measures according to which the general director's authority to represent the company could be restricted, the conclusion should be that the general director's authority to represent the company cannot be restricted.[58]

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[54] See Kashanina 2010 pp. 503-506 for recommended by-law contents.
[55] See Osterloh 2009. See Chapter 2.1.3 below for the management's competence in German joint stock companies.
[56] See HE 27/1977 vp p. 52. HE 109/2005 vp p. 86. Mähönen & Villa 2006b pp.165-168, 178. Taxell 1988 pp. 72-73, 77.
[57] See Prop. 1975:103 pp. 374-375. Skog 2009 pp. 163-164, 190-191. Sandström 2007 pp. 219-223.
[58] See Shitkina 2008 pp. 323-324.

> In Finland and Sweden the shareholders may provide for so-called dual signatory rights in the charter requiring the general director (or any other authorized person) to sign for the company together with another authorized person, which restricts the general director's authority to independently represent the company (OYL § 6:27.1, ABL § 8:39.1).[59]

The Law on Joint Stock Companies and the Law on Limited Liability Companies provides for certain restrictions to the general director's competence by the rules on major transactions and related party transactions. The original purpose of the rules on major transactions was to ensure minority shareholders a possibility to affect decisions related to the company's key assets in a similar manner that minority shareholders could affect decisions related to reorganizations. The lawmaker therefore established similar decision-making rules for major transactions as were applied to reorganizations, mainly requiring the general shareholders meeting to approve such transactions by qualified majority.[60] Hence, in joint stock companies, if the value of a transaction or the value of several related transactions exceeds 50% of the balance sheet value of the company's assets as per the previous financial statement, the general meeting of shareholders is required to approve the transaction. The approval requires a qualified ¾ majority of the shares represented at the meeting (LJSC § 79.3.1). Transactions, the value of which is between 25% and 50% of the balance sheet value of the company's assets should be approved by the board by a unanimous decision (LJSC § 79.2.1)[61]. If a unanimous decision cannot be reached, the board can request the general meeting of shareholders to approve the transaction (LJSC § 79.2.2).[62]

In limited liability companies major transactions are primarily approved by the general meeting of shareholders (LLLC § 46.3.1). However, the charter can assign the approval of major transactions, the value of which is between 25% and 50% of the value of the company's assets as per the previous financial statement, to the board of directors (LLLC § 46.4.1).[63] According to the wording of the law, the value of major transactions should in

[59] See HE 109/2005 vp p. 89. Mähönen & Villa 2006b p. 180. Prop. 2004/05:85 p. 630. Sandström 2007 pp. 224-225.
[60] Black & al. 1999 pp. 441-443. See OECD 2002 Sections 67-69 for background on the rules on major transactions.
[61] See Black & al. 1999 p. 446 according to which a unanimous decision is required since it should be considered that there is doubt of whether the transaction is in the interest of the company if even one board member votes against the transaction. Also SCC Letter of Instructions N 62 Section 9 in which the Supreme Commercial Court has clarified this requirement.
[62] See SCC Decree N 19 Section 32, paragraph 1-2. Shitkina 2007 p. 500.
[63] See Shitkina 2007 pp. 499-500.

limited liability companies be compared to the (net) assets of the company. In practice, however, the value of the transaction should also in limited liability companies be compared to the balance sheet value of the company's assets without reducing the value of the company's liabilities from the value of these assets.[64]

Major transactions comprise, amongst others transactions, loans, credits, securities and guarantees (LJSC § 78.1.1, LLLC § 46.1.1). When considering whether a transaction constitutes a major transaction the price of the acquired assets, or if assets are disposed of, the value of the assets as per the financial statements, should be held as basis for the evaluation (LJSC § 77.1.1, LLLC § 46.2.1).[65] It is important to note that the rules on major transactions do not apply to transactions belonging to the company's ordinary business operations (LJSC § 78.1.1, LJSC § 46.1.1).Transactions belonging to the company's ordinary business operations include, for example, acquisitions of raw materials and stock or reserves for manufacture and retail purposes, as well as loans necessary for performing these operations.[66] To clarify the scope of the ordinary business operations, the shareholders could specify the company's field of business in the charter.[67]

> In a recent decision the Supreme Commercial Court stated that a loan that is related to the ordinary business operations of the company should not be considered a major transaction regardless of the amount of the loan (SCC N VAS-16240/09). In other court practice a transaction has not been considered to require board or shareholder approval when a company which business activity comprised warehousing services concluded a construction contract for the renovation of its facilities, and when a company took a loan for improving its stock and reserves, regardless of that the value of these transactions exceeded the above-referenced thresholds (FCC Moscow Circuit N KG-A41/7615-06, FCC Moscow Circuit N KG-A40/12971-04, SCC N VAS-4753/10). In the latter cases the transactions were considered to belong to the company's ordinary business operations. On the other hand, a contract on legal services was not considered to belong to the company's ordinary business operations when the service fee equaled 79% of the balance sheet value of the company's assets (FCC Ural Circuit N F09-3143/06-S5).In court practice a security has been declared invalid, when the value of the loan to which the security was placed exceeded 25% of the company's balance sheet value (FCC North-Western Circuit N A56-8320/2008, SCC 3892/09). Transactions have been considered related when the companies that acquired separate parts of a real estate had mutual shareholders and managers. It did not matter that the purchase contracts were unconnected (SCC N 6172/09).

[64] SCC Letter of Instructions N 62 Section 3. FCC North-Caucasian Circuit N F08-5287/2005. Also FCC Moscow Circuit N KG-A40-/6527-08.
[65] SCC Decree N 19 Section 31, paragraph 1. See Shitkina 2007 pp. 496-499.
[66] SCC Decree N 19 Section 30, paragraph 5. See SCC Letter of Instructions N 62 Section 5. Shitkina 2007 pp. 395-396.
[67] A transaction concluded by the general director in conflict with the company's field of activity specified in the company's charter can also be declared invalid by a court on the basis of a claim filed by the company or a shareholder, if the other party knew or should have known that the transaction is not within the designated field of activity of the company (CC § 173.1.1, see Tolstoy 2010 p. 302).

The court practice shows that approval is not required for transactions that belong to the company's ordinary business operations, regardless of whether the value of the transaction exceeds the threshold values established for major transactions. Taking in consideration that the general director is according to the law only authorized to decide in matters belonging to the company's day-to-day operations, the function of the rules on major transactions is somewhat unclear. It seems that the rules attempt to define unusual or insignificant transactions requiring board or shareholder approval as transactions which value exceeds 25% of the balance sheet value of the company's assets. The rules, however, rather broaden the general director's authorities beyond the day-to-day operations to cover such transactions that do not belong to the company's ordinary business operations but which value, nonetheless, is less than 25% of the balance sheet value of the company's assets.[68]

> In German joint stock companies the charter or a by-law adopted by the board of directors is required to specify transactions that require the board of directors' prior approval (AktG § 111.4). The management board is required to obey such restrictions to its competence (AktG 82.2).[69] The *Aktiengesetz* does not provide for shareholder approval of transactions. However, the Federal Court of Justice has established an obligation for the management to revert to the general meeting of shareholders in fundamental matters that the management "… cannot reasonably expect itself to have authorization to resolve independently …". Such fundamental matters comprise in essence transactions related to the company's key assets (In the case the management intended to transfer the most profitable division of the company to a subsidiary. See BGHZ 83, 122 – *Holzmüller* and also BGH ZIP 2003, 387 - *Macrotron*). The decision was followed by a discussion on the value of transactions (suggestions were between 10-50% of the assets value, revenue and other indicators) that required shareholder approval and whether the same qualified majority (3/4) that applied to reorganizations would be required for the approval.[70] Later the Federal Court of Justice specified the aforementioned decision in the *Gelatine* cases and stated that shareholder approval is required if the transaction can strongly impact shareholder rights (pertaining to control) and the economic interest related to the shares, and if the nature of the transaction is such that it nearly requires amending the charter. The court considered that the value of the transaction should be of no less value than the value of the assets in the *Holzmüller* – case, i.e. at least 80% of the company's assets, and further that such transactions should be approved by a qualified 3/4 majority (BGH ZIP 2004, 993 – *Gelatine I*, BGH ZIP 2004, 1001 – *Gelatine II*).[71] In German limited liability companies the shareholders may freely specify restrictions to the management's authorities in the charter or otherwise decide on such restrictions, and thus transfer decision-making power to the general meeting of shareholders (GmbHG § 38.1). If the company has a board, the rules stipulated in the *Aktiengesetz* regarding board approval apply, unless otherwise specified in the charter

[68] See FCC North-Western Circuit N A56-20650/2009 in which the court did not consider the disposal of shares in a public company a major transaction, since the value of the transaction constituted only 24,04% of the balance sheet value of the company's assets.
[69] See Lieder 2010 pp. 127-129.
[70] See Löbbe 2004 pp. 1067-1068 for a summary of the discussion.
[71] See du Plessis & Saenger 2007 pp. 54-58. Löbbe 2004 pp. 1059-1069, 1071-1077.

(GmbHG § 52.1). In Finland and Sweden the board's competence comprises matters that are, taking in consideration the type and scope of the company's business, unusual or extensive. The general director is allowed to independently decide in such matters only with the board's authorization, unless there is a risk that the company suffers significant losses if the action is not taken immediately and the board's approval cannot be obtained in due time (OYL § 6:17.2, ABL § 8:29.2).[72] According to *Sandström*, unusual or extensive transactions depend on the value of the transaction – compared to the type and extent of the company's business, the term or duration of the transaction – far-reaching transactions are outside the general director's competence since the general director's competence covers the day-to-day operations an the internal distribution of authorities between the board and the general director – in particular restrictive or extending rules.[73]

It is evident that the Russian rules on major transactions are closer to the German system than to the Finnish and Swedish ones. However, taking in consideration that the German system allows the management to independently undertake almost any transaction as far as the transactions does not alienate a majority of the company's assets, or, as per the Russia law, as long as the transaction is related to the company's ordinary business operations, and taking in consideration the necessity to grant the shareholders relatively strong control over the management, which was the objective of the self-enforcing model, the Finnish and Swedish rules would seem more appropriate for the Russian environment, since they do not exclude all transactions related to the ordinary business operations from the board's and the general meeting of shareholders' competence.

The law allows to adjust the threshold values for major transactions and to extend the approval procedure pertaining to these transactions to other transactions by including a provision thereof in the charter (LJSC § 78.1.1, LLLC § 46.7.1). Shareholders can thus define other transactions that the shareholders consider particularly significant for the company in the charter and extend the approval procedure applying to major transactions to these transactions.[74] The Russian Corporate Governance Code for example recommends that transactions outside the scope of the business plan – so-called non-standard operations – and transactions, the value of which exceeds 10% of the balance sheet value of the company's assets, should require board approval.[75] The aforementioned threshold value does not necessarily need to be 10%. Instead the shareholders can specify another

[72] See HE 27/1977 vp p. 52. Prop. 1997/98:99 pp. 212-213. Prop. 1975:103 pp. 374.
[73] Sandström 2007 pp. 220-221.
[74] See Kashanina 2010 p. 570. It should be noted that this alternative may not be optimal in joint ventures incorporated as joint stock companies since the Law on Joint Stock Companies allows minority shareholders under certain circumstances to require the majority shareholders to redeem the minority shareholders' shares under the rules on majority transactions (LJSC § 75.1.1, see Shitkina 2008 pp. 325-326).
[75] FCSM Code Chapter 4 Section 1.1.3, paragraph 1, Chapter 8 Section 2.2.1, paragraph 1, Section 2.2.3, paragraph 1.

threshold value that is suitable for the subsidiary. The charter can alternatively specify a maximum value for transactions that the general director is authorized to execute independently. The restrictions may also restrict the general director's authority to execute certain types of transactions, such as transactions related to financing or real estate.

> Another way of restricting the general director's competence is to extend the competence of the general meeting of shareholders or the board in the charter to transactions that otherwise would belong to the competence of the general director. The restrictions could be similar to the ones referred to above in connection with the major transactions. In this case, however, it should be noted that the restrictions cannot be made in favor of the general meeting of shareholders in joint stock companies, since its competence cannot be extended by the charter to other issues than those provided for in the law, and nor can the restrictions, for the same reason, be made in favor of the board in limited liability companies.[76] These two issues make using the second option for restricting the general director's competence less convenient and lucrative compared to the first option. It should also be noted that under this alternative option any transactions concluded by the general director in violation of the restrictions should be contested in accordance with the Civil Code under which only the party in which interest the restriction was made is allowed to file the claim (CC § 174.1.1). The Supreme Commercial Court has determined that the party in which interest such restrictions are established constitutes the company itself, unless explicitly stated otherwise in the law, meaning that a shareholder cannot file such claim.[77] Under the new provisions introduced to the rules on major transactions in July 2009 also shareholders are authorized to file such claims (see below).

The general director is also required to submit so-called related party transactions for approval to the board and the general meeting of shareholders.[78] Related party transactions are transactions in which the general director or a relative or an affiliate[79] of the general director has an interest. In particular transactions where the general director or the general director's spouse, biological or adoptive parent, biological or adopted next in kind, brother, sister or an affiliate of the aforementioned parties is a party, a beneficiary or a representative of the other party, or an owner of, solely or jointly, no less than 20% of the charter capital of the other party, a beneficiary[80], or a representative of the other party, or a member of a governing body of the other party, including a member of a governing body

[76] See Chapters 2.3.1 and 3.1.1 below.
[77] SCC Decree N 9 Section 4, paragrah.2. The Supreme Commercial Court has confirmed that a shareholder cannot file a claim for declaring a transaction void under CC § 174.1.1 (SCC VAS-8105/09). On the other hand, for example *Krotov* deems that restrictions to the general director's authorities could be considered to have been established in the interest of the shareholders (Krotov 2010 pp. 303-305). See Budylin 2008 pp. 135-136.
[78] See OECD 2002 Sections 61-62 for an overview of the background on related party transactions in Russia.
[79] An affiliate is, according to the Competition Law, a person or entity that can affect the conduct of another legal entity or private person exercising commercial activities (CL § 4.1).
[80] A person or entity who is not a party to the transaction is considered a beneficiary, if the transaction relieves the person or entity from an obligation towards the company, or if the party receives a benefit by the execution of the transaction, such as a guarantee or insurance, or if a security is placed on behalf of this person or entity by the transaction (SCC Decree N 40 Section 1, paragraphs 2-3).

of a management company, a beneficiary or a representative of the other party, or is connected to or has an interest in the transaction in any other manner provided for in the charter are considered related party transactions (LJSC § 81.1.2, LLLC § 45.1.2).[81] The circumstances that entail an interest in the transaction should exist when the transaction is executed.[82]

> In court practice the parties of a transaction have been considered related, for example, when the general director-board member of the company granted a guarantee on behalf of the company to another company in which a relative of the general director-board member owned 30%, as well as when a person was general director of the lessor-seller and chairman of the board of the lessee-buyer (SCC N 14461/07, SCC N 14432/08).

The general director is required to inform the board, revision commission and the auditor, and in limited liability companies, the general meeting of shareholders, of any companies in which the general director or a relative or an affiliate of the general director owns more than 20% of the company's charter capital and of companies in which the aforementioned parties hold a position in any of their governing bodies, as well as of any transactions in which the aforementioned can be considered to have an interest (LJSC § 82.11, LLLC § 45.2.1).[83]

In joint stock companies related party transactions are approved by independent board members, if the value of the transaction is less than 2% of the balance sheet value of the company's assets as per the previous financial statement (LJSC § 83.2.1). If the value of the transaction exceeds this threshold, or if the board lacks a sufficient number of independent board members to approve the transaction, the transaction is approved by the general meeting of shareholders. Only shareholders that lack an interest in the transaction can participate in the vote (LJSC 83.4.1). In limited liability companies related party transactions are approved by the general meeting of shareholders (LLLC § 45.3.1). Approval of the transaction requires that a majority of the shareholders that lack an interest in the transaction is in favor of the transaction (LLLC § 45.3.2). However, if a limited liability company has a board, the charter may assign the approval of such related party transactions which value is less than 2% of the value of the company's assets to the board (LLLC § 45.7.1).[84] Related party transactions should be approved before their execution.[85]

[81] See SCC Decree N 19 Section 33, paragraph 1. Shitkina 2007 pp. 507-508.
[82] SCC Decree N 19 Section 33, paragraph 2. SCC Letter of Instructions N 62 Section 14.
[83] See Shitkina 2007 pp. 508-509.
[84] See SCC Decree N 19 Section 34, paragraphs 3, 7. Shitkina 2007 pp. 515-519.

If the general director executes a major or related party transaction in violation of the above-referenced rules, a shareholder or the company can file a claim for declaring the transaction invalid (LJSC § 79.6.1, LJSC § 84.1.1, LLLC § 46.5.1, LLLC § 45.5.1).[86] A court can refrain from supporting such claim only if it is not shown that the transaction caused the shareholder or the company, depending on which files the claim, damage or other negative consequences or if the other party shows that it neither new or should have known that the transaction was executed in conflict with the rules on major or related party transactions, as well as if the transaction was subsequently approved by the competent governing body or the shareholder could not have affected the approval of the transaction even if approval had been requested (LJSC § 79.6.3, LJSC § 84.1.3, LLLC § 45.5.3, LLLC § 46.5.3).[87] Hence, presuming that the shareholder filing the claim is a majority shareholder and did not subsequently approve the transaction, the shareholder should show that the shareholder suffered a loss through the transaction and that the other party knew or should have known that the transaction lacked necessary approval.

The former requirement follows likely from an earlier decree of the Supreme Commercial Court requiring a shareholder filing a claim for voiding a transaction executed by the general director to show that the shareholder's rights or legal interests were violated.[88] In regards to related party transactions the Supreme Commercial Court has verified that if it is shown that the company has suffered a loss owing to the transaction, it should be presumed, unless the contrary is shown, that the shareholders' rights and legal interest were violated by the transaction.[89] Such presumption has however not been established in relation to major transactions. The same presumption should, however, apply to major transactions, since the main purpose of the rules on major transactions and the rules on related party transactions is similar, i.e. to safeguard the company's assets and allow the shareholders to control them in certain extent.[90] Alternatively the shareholder could file a

[85] SCC Decree N 19 Section 34, paragraph 1.
[86] See SCC Decree N 19 Section 36, paragraph 1. SCC Decree N 40 Section 2, paragraph 1. SCC Letter of Instructions N 62 Section 12. In court practice a shareholder has been refused the right to file a claim regarding a major transaction when the shareholder became shareholder only after the transaction was executed (FCC North-Western Circuit N A21-7351/2003).
[87] See Mayfat 2009.
[88] SCC Decree N 19 Section 38, paragraph 2.
[89] SCC Decree N 40 Section 3, paragraph 3.
[90] The Supreme Commercial Court is currently preparing a Letter of Instructions regarding the amendments to the law, which will hopefully clarify the situation (SCC Letter N VAS-SOY/YCHP-1598).

claim for voiding a major transaction executed by the general director in violation with the rules on major transactions in the name of the company, in which case it is sufficient to show that the company suffered a loss by the execution of transaction. This may, however, require that the general director is removed and a new one is appointed to file the claim.

> In a recent decision the Supreme Commercial Court acknowledged that the shareholder's right to profit (dividend) constitutes a shareholder right that can be violated by a related party transaction if the transaction can cause a loss to the company. In the case a board member and a shareholder-board member concluded an agreement for appointing the latter as general director of the company, the agreement including a significant "golden handshake" in case of premature termination (SCC N 17255/09).

The court can also dismiss the claim if it is shown that the other party neither new or should have known that the transaction was executed in violation of the rules on major or related party transactions. Despite that the provision does not state which party carries the burden of proof, it in practice presumably comes to the shareholder or the company to show that the other party should have known that the rules were not followed. The Supreme Commercial Court has clarified (in relation to CC § 174) in what manner courts should evaluate whether the other party knew or should have known that the general director acted beyond its competence when concluding the transaction. If analogically applying this guidance, the court should consider the circumstances as a whole, in which case, for example, the fact that it is stated in an agreement that the general director acts on the basis of the charter, should not suffice as evidence of the fact that the other party should have known of a restriction.[91]

> It has been considered in court practice, for example, that a bank should have known of a restriction to the general director's authorities when the company had been required to submit the charter to the bank on the basis of other customer relations (FCC Ural Circuit F09-9868/06-S5).

A claim for declaring a transaction concluded in violation of the above-referenced rules on major and related party transactions should be filed within 1 year from the day that the shareholder became aware of the transaction (CC § 181.2.1). Invalid transactions do not entail legal consequences and the parties of the transaction are required to return to the other party what they received under the transaction (CC § 167.1.1, CC § 167.1.2).[92] It seems, by virtue of court practice, that under ordinary circumstances a shareholder that has

[91] See SCC Decree N 9 Section 5, paragraph 2. Mayfat 2009.
[92] See Krotov 2010 p. 316. Gutnikov 2008 pp. 184-188.

access to the company's documents and being required to approve the annual reports under the law, should become aware of the transaction not later than at the following annual general meeting of shareholders.

> A sole shareholder should have become aware of a security placed during the previous financial year at the annual general meeting of shareholders, since the shareholder is required to approve the annual reports and is entitled to receive information on the company's activities and has access to the company's accounts (SCC N 1656/07, also SCC N 12384/08).

2.1.3. The Management Board's Authorities

As was mentioned above, the company's day-to-day operations may be managed by the general director together with a management board (CC § 91.2.1, CC § 103.3.1, LJSC § 69.1.1, LLLC § 32.4.1). Similarly to the general director, also management board members are appointed and removed by either the general meeting of shareholders or the board of directors (LSCJ 69.3.1, LLLC § 41.1.1).[93] The Russian Corporate Governance Code recommends companies to establish a management board for resolving the most complex matters pertaining to the company's day-to-day operations.[94] Only individuals can be elected to the management board (LLLC § 41.1.2).[95]

The management board usually consists of managers and heads of departments employed by the company. The management board can include, for example, chiefs and heads of departments, such as the chief financial officer, the chief legal counsel, the marketing and sales director, the head of purchases, the head of public relations and the head of research and development.[96] The composition of the management board is up to the shareholders, as the law does not set forth any requirements for the composition of the management board. When deciding upon the management board's composition, the shareholders should attempt to create a structure that facilitates productive and constructive discussion, efficient work and prompt decision-making.[97]

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[93] See Yudenkov & Mozolin 2010 pp. 116, 133-134. Lapteva & Zankovsky 2006 p. 121. Makarova 2005 p. 263. Shitkina 2007 p. 355. Mogilevskiy 2010 336.
[94] FCSM Code Chapter 1 Section 4.1, paragraph 1, Chapter 4 Section 1.1, paragraph1, Section 1.1.1, paragraph1.
[95] The Law on Joint Stock Companies does not separately state that the management board members should be individuals, but this should however be the case (See e.g. Kashanina 2010 p. 478. Shitkina 2007 p. 356).
[96] RCGM 2004 Chapter 5 pp. 86-87. Shitkina 2007 p. 357.
[97] FCSM Code Chapter 4 Section 2.1.5, paragraph 2.

If the management board is established in a joint stock company, the charter should set forth its competence, composition and decisions-making procedures, while a mandatory by-law, called for example, the Management Board Policy, should specify the frequency of its meetings, as well as the procedure for convening and holding management board meetings and its decision-making procedures (LJSC § 69.1.2, LJSC § 70.1.1, LJSC § 11.3.1). In limited liability companies a Management Board Policy is not mandatory. The aforementioned rules can be included in the charter at the shareholders discretion (LLLC § 41.2.1). The shareholders should, however, note that including the more detailed rules in a by-law brings flexibility, since changing the rules does not require that the charter is amended. In any case, the management board's composition, competence and decision-making procedures should be stipulated in the charter (LLLC § 12.2.1). In both company forms the charter should provide for the Management Board Policy if it is established and specify its main content and the governing body responsible for adopting it.[98]

> A management board is also found in German joint stock companies, where the management board's task is to direct and manage the company, as well as to represent the company in relation to third parties (AktG § 76.1-2, AktG § 77.1, AktG § 78.1). The management board's right to represent the company cannot be restricted, but it should be noted that the charter or a by-law adopted by the supervisory board is required to provide for transactions that the management board is authorized to undertake only with the supervisory board's approval (AktG § 82.1, AktG § 111.4). The general meeting of shareholders can participate in the management of the company only upon the management board's request (AktG § 109.2).[99] Neither the Finnish nor the Swedish company laws provide for a management board. However, for example *Taxell* writes that the management of many companies involves an informal management board which members comprise other managers of the company. It does however not affect the general director's authorities, decision-making power and responsibility for managing the company, but rather constitutes a delegation of the workload.[100]

The Russian Corporate Governance Code recommends that approval of transactions, the value of which exceeds 5% of the company's assets, is assigned to the management board's competence. The management board should also, according to the code, prepare by-laws and the business plan for the board of directors' or the general meeting of shareholders' approval, approve internal documents assigned to the management's competence, including work schedules and job descriptions and incentive payment

[98] See FCSM Code Chapter 4 Section 1.1.1, paragraph 2. See Telyukina 2005 p. 457. Mogilevskiy 2010 p. 338.
[99] See du Plessis & Saenger 2007 pp. 50-51, 53-54. Böttcher & Blasche 2010 pp. 493-500. GCGC 2010 Section 4.1.1-4.1.2. See Chapter 2.1.2 regarding the *Holzmüller* -case.
[100] Taxell 1988 p. 89.

procedures, approve real estate transactions and loans, elect the management of subsidiaries and approve the agenda of and appoint representatives to the general meeting of shareholders of the company's subsidiaries, as well as prepare voting instructions for the representatives and determine the compensation and other terms and conditions of the employment agreements of the company's employees.[101]

Most of the above-referenced issues that the Russian Corporate Governance Code recommends to include in the competence of the management board are matters that should rather be assigned to the competence of the board of directors or the general meeting of shareholders to enhance supervision and control of the company and its management. This concerns in particular approvals of real estate transactions and loans, electing the management of subsidiaries and approving the agenda of and appointing representatives to the general meeting of shareholders of subsidiaries.

It is also important to note that if a formal management board is established, the general director is required to act in accordance with the management board's decisions in matters assigned to the management board's competence. Hence, if the shareholder appoints a foreign general director, for example, from its own organization to govern and control the Russian subsidiary, the management board, if established, should not be vested with authorities that allow it to hinder the general director from managing the company and controlling its activities.

2.1.4. External Management

The general director's authorities can be transferred to a so-called management company that by the transfer of the authorities becomes responsible for conducting the company's day-to-day operations (CC § 103.3.3, LJSC § 69.1.3, LLLC § 42.1.1).[102] The management company can be either a Russian or foreign entity. According to *Shitkina* transferring the executive management to a management company can be convenient especially in groups, since it allows to transfer the management of subsidiaries to a parent company or another group company, thus facilitating the management of the group. Concentrating management of subsidiaries to one company may also enable the group to save in

[101] FCSM Code Chapter 4 Sections 1.1.2-1.1.5. Mogilevskiy 2010 p. 337-338. Shitkina 2007 p. 355.
[102] See Shitkina 2007 p. 353-354. Mogilevskiy 2010 pp. 362-363.

management costs, as a separate management for each subsidiary is not required.[103] A foreign shareholder can thus concentrate the management of all or a part of the group's Russian companies to one of the group companies to facilitate supervision of the Russian operations. In theory the management company could be one of the group's foreign entities, such as a parent company.

In joint stock companies the decision to transfer the general director's authorities to a management company is adopted by the general meeting of shareholders on the board's proposal (LJSC § 69.1.3). However, if appointing and removing the executive management has been assigned to the board of directors' competence, the board may elect and appoint the management company after the general meeting of shareholders decision to transfer the management to a management company.[104] In limited liability companies the competent governing body depends on which governing body, either the general meeting of shareholders or the board, is vested with the authority to appoint and remove the management (LLLC § 32.2.1.1, item 2, LLLC § 33.2.1, item 4).[105] Despite that not specifically required by the law, the charter of both company types should provide for the possibility to hire a management company, since the charter should contain information on the company's governing bodies (LJSC § 11.3.1, LLLC § 12.2.1). After transfer of the general director's authorities to the management company, the company is represented by the management company and assumes rights and obligations through the management company (LJSC § 69.3.5, LLLC § 42.2.1).

2.2. Management Reporting Duties

As was mentioned above, the potential asymmetry of information in shareholder-management relations makes it difficult for the shareholders to assure themselves that the management acts solely in the interest of the company and its shareholders. The Russian company laws state that the management is accountable toward the board of directors and the general meeting of shareholders (LJSC § 69.1.1, LLLC § 32.4.1). However, except for the responsibility to prepare the annual reports and arrange the company's accounting, the laws do not establish any periodical or other reporting duties for the management. Thus, if other reports are not separately requested, the shareholders may receive information on the

[103] Shitkina 2007 p. 348.
[104] See Shitkina 2007 p. 349.
[105] Mogilevskiy 2010 p. 357.

company and its activities only annually in connection with the annual general meeting of shareholders. To ensure more frequent information on the company's operations, the shareholders should establish more comprehensive reporting duties for the management.

> In Germany the management board of a joint stock company has relatively comprehensive reporting duties toward the supervisory board. The management board should provide the supervisory board with complete and accurate reports concerning strategies and development plans related to, especially, the company's finances, investment plans and personnel (annually or more often), the company's liquidity, especially regarding own capital (at relevant supervisory board meetings), the market and the company's market situation (quarterly or more often), and significant transactions that may affect the company's liquidity significantly (AktG § 90.1-4).[106] The management of a German limited liability company does not have similar reporting duties. In Finland the general director is required to provide the board of directors with information that the board needs for performing its duties and responsibilities (OYL § 6:17.1). According to the government bill, the general director is required to provide this information – which the board may specify – on its own initiative.[107] The information may relate to, for example, the company's sales and revenue expectations, the company's liquidity and similar issues.[108] In Swedish companies the board should establish a reporting system by issuing written instructions that provide for reports and information that the other company bodies should provide the board with to allow the board to continuously assess the company's financial situation. Such reporting system is, however, not required, if the reports would not, taking in consideration the size of the company, affect the board's possibilities to receive the necessary information in any significant extent (ABL § 8:5.1).[109]

The Russian Corporate Governance Code recommends companies to establish a by-law to regulate disclosure of information on the company and its activities.[110] Notwithstanding that the provisions of the Russian Corporate Governance Code are primarily addressed to public companies, also private companies could utilize such a by-law – called for example the Information Policy – to establish management reporting duties. The objective of the by-law should be to ensure that the shareholders and the board of directors have timely, accurate and comprehensive information on the company and its activities. Hence, it could specify the information that the management is required to provide to the board and the shareholders and when this information should be provided. It could also regulate other issues concerning internal information flows.[111] If the shareholders decide to establish an Information Policy, the provisions regarding its purpose, approval and content should be set forth in the charter.

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[106] See GCGC 2010 Section 4.1, paragraphs 1-3. Lieder 2010 pp. 119-120.
[107] HE 109/205 vp p. 86.
[108] Kyläkallio & al. 2008 p. 675.
[109] See Prop. 1997/98:99 p. 198. Prop 2004/05:85 pp. 618.
[110] FCSM Code Chapter 7 Section 1.1.1-1.1.2.
[111] See Yeremichev & Pavlov 2010 pp. 233-235.

2.3. Shareholder Authorities

2.3.1. The Competence of the General Meeting of Shareholders

Shareholder authorities are essential for shareholders, since these authorities allow the shareholders to control the company and its management, at the same time allowing them to supervise the assets invested into the company. The shareholders exercise their authorities at the general meeting of shareholders, which constitutes the company's supreme governing body (CC § 103.1.1, LJSC § 47.1.1, CC § 91.1.1, LLLC § 32.1.1). It is the only venue in which the shareholders can make decisions related to the company and its activities. Both the Law on Joint Stock Companies and the Law on Limited Liability Companies contain a list of specific matters belonging to the competence of the general meeting of shareholders, providing the general meeting of shareholders certain key authorities related to the company and its management (CC § 103.1.2, LJSC § 48.1.1, CC § 91.3.1, LLLC § 33.2.1).[112]

Firstly, the general meeting of shareholders has the exclusive competence to amend the charter and determine the primary directions of the company (LJSC § 48.1.1, items 1-2, LLLC § 33.2.1, items 2, 11).[113] The law thus provides the shareholders with an exclusive authority to determine the fundamental rules applying to the company, its organization and activities, as well as to determine its goals and objectives and its field of business. The general meeting of shareholders also has the authority to approve by-laws that direct the activities of the company's organization, including the activities of the management and the board (LJSC § 48.1.1, item 19, LLLC § 32.2.1, item 8).[114] Adopting by-laws can in limited liability companies be extensively delegated to the board.

Secondly, the general meeting of shareholders has the exclusive competence to elect and remove the board of directors and the executive management, unless the latter is assigned to the board's competence (LJSC § 48.1.1, items 4, 8, LLLC § 33.2.1, item 4). The general director can be removed at the shareholders' discretion without the necessity to provide a specific reason for the removal (LC § 278.1, item 2, LJSC § 69.4.1). If the charter provides

[112] See Yudenkok Mozolin 2010 pp. 116, 132. Makarov 2005 pp. 214-215. Mogilevskiy 2010 p. 277. Since the authorities specified in the Civil Code are included in the company laws, only the provisions of the latter are discussed here.
[113] See Telyukina 2005 p. 302. Ignatova 2006 p. 168.
[114] See Telyukina 2005 pp. 305-306. Ignatova 2006 p. 169-170.

for it, the separate labor law rules pertaining to the general director can be extended to the management board members, which allows the shareholders to also remove management boards member without a specific reason (LC § 281.1).[115] The authority to remove the general director is the most significant authority granted to the shareholders, since it allows the shareholders to remove bad managers and pursues the management to act properly. Since the Law on Limited Liability Companies lacks provisions related to the appointment and removal of the board, the shareholders should include such provisions in the charter (LLLC § 32.2.2).[116]

Thirdly, the general meeting of shareholders has certain authorities specifically related to controlling the company and its activities, including the authority to approve major transactions and related party transactions, to appoint the external auditor, to appoint and remove the revision commission, if the company has one, and to review and approve the annual reports (LJSC § 48.1.1, items 9-11, 15-16, LLLC § 33.2.1, items 1, 5-6, 10, LLLC § 45.3.1, LLLC § 46.3.1). Fourthly, the general meeting of shareholders is entitled to decide on distribution of dividend, which constitutes the shareholders' main economic right (LJSC § 48.1.1, items 10.1, 11, LLLC § 32.2.1, item 7).[117]

In joint stock companies the shareholders are specifically prohibited from resolving any other matters than those matters assigned to the competence of the general meeting of shareholders by the law (LJSC § 48.3.1). Any decisions taken by the general meeting of shareholders in matters outside its competence are void.[118] Some criticism has been presented against this restriction to the authorities of the shareholders. According to *Kruglova*, for example, the restriction contradicts with generally accepted principles of management hierarchy, according to which the company's supreme governing body should have the authority to decide in any issue pertaining to the company and its activities.[119] *Dolinskaya* considers that since the authorities of the other company bodies derive from the authority of the general meeting of shareholders, the company's supreme governing body, the general meeting of shareholders should be competent to resolve any matter

[115] See Chapter 5.4 below for more details on the shareholders' right to remove the management.
[116] See Telyukina 2005 pp. 303-304. Ignatova 2006 p. 168.
[117] See Kashanina 2010 p. 459. Telyukina 2005 pp. 304-305. Ignatova 2006 pp. 169-170.
[118] SCC Decree N 19 Section 26. See Kashanina 2010 pp. 463-465. Telyukina 2005 p. 306-307.
[119] Kruglova 2001 p. 131 - 132.

pertaining to the company and its business operations.[120] According to *Black & al.*, it would be more appropriate to provide for matters that the general meeting of shareholders are required to resolve in the law, but allow the shareholders to determine other matters in the charter.[121] In limited liability companies the shareholders can extend the competence of the general meeting of shareholders by including provisions thereof in the charter (LLLC § 33.2.1, item 13).[122]

> Similar restricted shareholder authorities can be found in German joint stock companies, where the shareholders have the authority to decide in matters pertaining to the management of the company only on the management board's request (AktG § 76.1, AktG § 119.2). The general meeting of shareholders' authority includes the authority to amend the charter, appoint the board of directors, approve the annual reports, appoint the auditors and remove the management board members and to resolve other issues specified in the charter (AktG § 119.1). It is worth noting that the law does not provide the shareholders with the authority to approve major or related party transactions, but on the other hand the charter or the supervisory board should set forth transactions that the management may execute only with the board's approval (AktG § 111.4).[123] In Finland the competence of the general meeting of shareholders comprises the issues assigned to its competence by the law and the charter, which may assign matters related to the company's ordinary business operations to the competence of the general meeting of shareholders. Moreover, the shareholders may by a unanimous decision undertake to resolve any matter belonging to the general director's or the board of directors' competence (OYL § 5:2.1). The Finnish law thus goes one step further from the Russian Law on Limited Liability Companies and allows shareholders to decide on practically any matter related to the company's activities by a unanimous decision. This system seems appropriate especially in smaller companies, where it provides the shareholders more extensive authorities in relation to the management.[124]

The shareholders thus lack authority in matters related to the ordinary business operations of the company in both company forms. However, the shareholders still have quite extensive possibilities to control the company's operations and the management, since the law allows the charter to specify transactions requiring board or shareholder approval under the rules on major transactions. The shareholders may utilize this possibility to transfer decision-making power to the general meeting of shareholders in significant matters. In limited liability companies the shareholders can also extend the competence of the general meeting of shareholders freely to other significant matters (LJSC § 78.1.1,

[120] Dolinskaya 2006 pp. 509-510, 519.
[121] Black & al. 1999 p. 315.
[122] See Mogilevksiy 2010 p. 282.
[123] See Grundmann & Möslein 2008 chapter 3. Böttcher & Blasche 2010 pp. 494. See Chapter 2.1.2 for an account of the *Holzmüller* -doctrine and how the general meeting of shareholders' authorities have been extended beyond the wording of the law in German case law.
[124] See HE 109/2005 vp p. 66. Mähönen & Villa 2006b pp. 54-55, 58-59.

LLLC § 46.7.1, LLLC § 33.2.1, item 13).[125] It should also be noted that in joint stock companies any additional authorities or duties assigned to the board by the charter are transferred to the general meeting of shareholders if the company lacks a board, since the responsibility to carry out the board's responsibilities transfers to the general meeting of shareholders if provided for in the charter (LJSC § 64.1.2).[126]

Matters assigned to the exclusive competence of the general meeting of shareholders cannot be delegated to the executive management in joint stock companies, but can be delegated to the board of directors when this is provided for in the law (CC § 103.1.4, LJSC § 48.2.1, LJSC § 48.2.2). Of the above-referenced authorities only the appointment of the executive management can be assigned to the board (LJSC § 48.1.1, item 8). In limited liability companies the election and removal of the executive management can be assigned to the board, while making amendments to the charter, appointing and removing the revision commission, approving the annual reports and deciding on dividends belong to the exclusive competence of the general meeting of shareholders (LLLC § 33.2.1, item 4, LLLC § 33.2.2).[127]

2.3.2. The General Meeting of Shareholders

The shareholders exercise their authority to direct and control the company and its operations at the general meeting of shareholders, where they also receive information on the company's operations, strategies and plans.[128] Each shareholder is entitled to participate in the general meeting of shareholders (LJSC § 31.2.1, LLLC § 32.1.2). There are two types of general meetings – the annual general meeting of shareholders and the extraordinary general meeting of shareholders (LJCS § 47.1.3, LLLC § 34.1.1, LLLC § 35.1.1).[129] The company laws provide for a simplified procedure for holding the general meeting of shareholders applicable in companies with only one shareholder. In this case the shareholder is not required to follow any other form requirements pertaining to the general meeting of shareholders except for preparing its resolutions in written form. The rules related to preparing, convening and holding the general meeting of shareholders do

[125] See Chapter 2.1.2 above.
[126] See Shitkina 2008 p. 329-330.
[127] See Telyukina 2005 p. 306. Shitkina 2007 pp. 312-313.
[128] See Makarov 2005 p. 214.
[129] See Lapteva & Zankovsky 2006 pp. 119-120. In fact, the meetings are referred to as regular and irregular meetings in regards to limited liability companies.

not apply, except for the term for holding the annual meeting of shareholders (LJSC § 47.3.1, LLLC § 39.1.1).[130]

The annual general meeting of shareholders shall take place within the period specified in the charter. According to the law, however, the annual general meeting of shareholders should be held not earlier than two months, and not later than six months, from the end of the financial year (LJSC § 47.1.3). In limited liability companies the annual general meeting of shareholders should not be held earlier than two months, but not later than four months, from the end of the financial year (LLLC § 34.2.1).[131] In joint stock companies the annual meeting of shareholders should approve the annual reports, decide on dividends, elect the board of directors, the auditor and the revision commission, and resolve other matters included in the agenda, while the only mandatory issue that the shareholders should attend to at the annual meeting of shareholders in limited liability companies is the approval of the annual reports (LJSC § 47.1.3, LLLC § 34.2.1).[132]

In joint stock companies the general meeting of shareholders is convened by the board of directors (LJSC § 65.1.2, item 2). If the company lacks a board of directors, the charter should set forth the body responsible for convening the meeting – usually the general director (LJSC § 64.1.2). In limited liability companies the general meeting of shareholders is convened by the general director (LLLC § 34.1.1, LLLC § 35.2.1). However, if the company has a board of directors, the responsibility to convene the general meeting of shareholders can be assigned to the board in the charter (LLLC § 32.2.2).[133]

An extraordinary general meeting of shareholders can in joint stock companies be convened by the board and in limited liability companies by the general director at their discretion. The revision committee and the external auditor, as well as a shareholder or a group of shareholders holding at least 10% of the company's shares, and in joint stock companies also the general director (or another body entitled to convene the general meeting of shareholders) if the company lacks a board, and in limited liability companies also the board (if established), are further entitled to request an extraordinary general meeting of shareholders (LJSC § 55.1.1, LLLC § 35.2.1). If another body than the board in

[130] See Shitkina 2007 pp. 359-361.
[131] See Kashanina 2010 p. 458. Mogilevskiy 2010 p. 290.
[132] See Kashanina 2006 p. 408. Shitkina 2007 pp. 314, 317. Mogilevksiy 2010 pp. 289-290.
[133] See Shitkina 2007 pp. 319-320.

joint stock companies or the general director in limited liability companies request an extraordinary general meeting of shareholders, the board, and respectively the general director, is required to make a decision on holding an extraordinary general meeting of shareholders within five days from receipt of the request (LJSC § 55.6.1, LLLC § 35.2.2). If the board of directors or the general director fails to make the decision within the five-day-period, the party requesting the meeting is entitled to convene the meeting (LJSC § 55.8.1, LLLC § 35.4.1).[134]

In joint stock companies the general meeting of shareholders is competent when at least half of its voting shares are represented at the meeting (LJSC § 58.1.1). The shareholders cannot make decisions in matters that are not on the agenda of the meeting and they are prohibited from making amendments to the agenda (LJSC § 49.6.1). The shareholders resolve the matters on the agenda by majority votes, unless another majority is provided for in the law (LJSC § 49.2.1). For example amending the charter requires that a qualified ¾ majority of the shares represented at the meeting support the decision (LJSC § 49.4.1).[135] The shareholders are required to follow the agenda of the meeting also in limited liability companies, but unlike in joint stock companies, they may undertake to resolve other matters than those provided for in the agenda if each of the company's shareholders are present at the meeting (LLLC § 37.7.1). Decisions require in limited liability companies an ordinary majority of all shareholders, i.e. of all the company's shareholders, not only those represented at the meeting, except for certain matters, including amending the charter, requiring a qualified 2/3 majority of all the company's shareholders (LLLC § 37.8.1, LLLC § 37.8.3).[136]

In joint stock companies any shareholder holding solely or jointly with other shareholders at least 2 % of the company's voting shares is entitled to propose matters to the agenda of the meeting before 30 days have passed since the end of the financial year, while in limited liability companies each shareholder is entitled to propose matters to the agenda, but not later than 15 days prior to the meeting (LJSC § 53.1.1, LLLC § 36.2.2). In joint stock companies the board or the general director is entitled to refrain from including the proposed matter in the agenda only if the shareholder fails to submit the proposal within

[134] See Kashanina 2010 pp. 458-459. Mogilevskiy 2010 pp. 290-291.
[135] See Kashanina 2010 pp. 463-464. Telyukina 2005 pp. 310-311, 314-315.
[136] See Mogilevskiy 2010 pp. 312-314.

the term specified in the law, if the shareholder does not own a sufficient number of shares in the company, if the proposal lacks the information specified in the law or if the proposed matter does not belong to the competence of the general meeting of shareholders (LJSC § 53.5.1). In limited liability companies the board or general director is entitled to refrain from including a matter in the agenda only if the matter does not belong to the competence of the general meeting of shareholders or if the matter is unlawful in some other manner (LLLC § 36.2.2). The company body convening the meeting is prohibited from making any modifications to the formulation of the matters proposed to the agenda (LJSC § 53.7.1, LLLC § 36.2.3).[137]

2.4. Access to Information

To control the company and its management and to make appropriate decisions in matters related to the company's activities, the shareholders need accurate information on the company and its activities. The right to access such information can be divided into two types of access rights – the right to access materials and information on the company's activities in connection with the general meeting of shareholders and the right to access such information outside the general meeting of shareholders. The shareholders' right to information is essential for decreasing the asymmetry of information between the shareholders and the management. In addition to information provided by the management and the board, a shareholder may need or want to review information and materials related to the company between the annual meetings on its own initiative. The shareholders are granted such access rights in both joint stock and limited liability companies. In the Law on Limited Liability Companies this right is expressed as one of the main shareholder rights (LLLC § 8.1.1).

In connection with the general meeting of shareholders the shareholders should be provided with the annual reports, including the audit report and the statement of the revision commission, information on candidates nominated for positions in the board, management board, revision commission or for general director, draft amendments to the charter, draft resolutions proposed for the general meeting of shareholders (only joint stock companies, but could be provided for in the charter of a limited liability company), information on shareholder agreements concluded during the financial year (only joint

[137] See Shitkina 2007 pp. 320-321. Mogilevskiy pp. 178-179.

stock companies, but could be provided for in the charter of a limited liability company if relevant) and other materials specified in the charter (LJSC § 52.3.1, LLLC § 36.3.1).[138] In addition, shareholders of a joint stock company should be provided with the board's recommendation on dividend and consents from candidates nominated for positions in the aforementioned bodies.[139]

The charter may also provide for other information and documents that should be provided to the shareholders in connection with the general meeting of shareholders. The Russian Corporate Governance Code recommends that the board prepares a report to the shareholders regarding the company's activities to allow the shareholders to evaluate the company's performance and growth prospects, as well as to allow the shareholders to evaluate the performance of the management and the practices and policies it has pursued.[140] The shareholders are, however, allowed to freely specify any other information or materials that are relevant for assessing the company's and the management's performance and to require that these are provided to the shareholders in connection with the general meeting of shareholders.

In joint stock companies the notice of the general meeting of shareholders, which should be sent by registered mail to each shareholder or alternatively be handed over in person, unless otherwise provided for by the charter, should specify where the shareholders may familiarize themselves with the information and materials related to the issues on the agenda of the general meeting of shareholders (LJSC § 52.2.1, LJSC § 52.1.3). The information and materials should be held available for the shareholders at the company's headquarters and in other locations indicated in the notice not later than 20 days before the meeting (LJSC § 52.3.3).[141] In limited liability companies the information and materials pertaining to the matters on the agenda of the meeting should be sent to the shareholders together with the notice of the meeting, which should be delivered by registered mail or by any other means provided for by the charter (e.g. by email) [142] to the shareholders 30 days in advance of the meeting (LLLC § 36.1.1, LLLC § 36.3.2). In both company forms the company is required to provide copies of the materials to a shareholder on the shareholders

[138] See Makarov 2005 p. 217. RCGM 2004 Chapter 8 pp. 59-60.
[139] FCSM Decree N 17/ps Sections 3.2-3.3.
[140] FCSM Code Chapter 2 Section 1.3.1, paragraph 3.
[141] See Shitkina 2007 pp. 321-322. RCGM 2004 Chapter 8 pp. 56-58.
[142] RCGM 2004 Chapter 8 p. 57.

request for a fee not exceeding the cost of preparing the copies (LJSC § 52.3.4, LLLC § 36.3.3).[143]

The company laws also grant the shareholders access to information related to the company and its activities outside the general meetings, as a company is required to provide its shareholders access to the company documents that the law requires a company to store (LJSC § 91.1.1, LLLC § 50.4.1).[144] The charter of a limited liability company should contain information on which documents the company should store, while this is not required for joint stock companies (LLLC § 12.2.1). Preferably the shareholders should specify in both company forms any additional materials that should be stored, or refer to the Information Policy, which in this case should specify the documents. In joint stock companies requested documents should be provided within 7 days from receipt of the request, while the term constitutes 3 days in limited liability companies (LJSC § 91.2.1, LLLC § 50.4.1).[145]

These documents include, amongst certain other materials, the founding agreement, the charter, the company registration certificate, title documents, by-laws and other internal documents, annual reports and financial statements, accounting documents (in joint stock companies only shareholders holding at least 25% of the company's shares are entitled to access these documents, while in limited liability companies each shareholder has the right to review the accounting documents)[146], statements of independent appraisers, shareholder registers, audit reports, statements of the revision commission and statements of government authorities charged with financial control functions, judicial acts (not in limited liability companies, but could be provided for in the charter), and other documents specified in the law, the charter, and by-laws or in shareholder, board or management decisions (LJSC § 89.1.1, LLLC § 50.1.1, LLLC § 30.1.1.2).[147]

In both company forms the shareholders may specify other documents that the shareholders should be guaranteed access to in the charter. The Russian Corporate

[143] See Shitkina 2007 pp. 321-322. RCGM 2004 Chapter 8 pp. 56-58.
[144] See RCGM 2004 Chapter 7 pp. 13-14.
[145] See Telyakina 2005 pp. 616-617. Makarova 2005 pp. 323-324.
[146] Follows in regards to limited liability companies from the Accounting Law (AL § 15.1.1).
[147] See Shitkina 2007 pp. 408-409. Telyakina 2005 pp. 609-611. See FCSM Decree N 03-33/ps regarding the procedure and terms for archiving documents of joint stock companies.

Governance Code recommends including voting results from board and management board meetings and the votes of each board and management board member amongst those documents, as well as materials presented at board meetings.[148] Other such materials could include information on plans and performance expectations, information on significant transactions and relevant contracts and other related documents and other materials that the shareholders deem necessary for directing and controlling the company and its management. The law thus provides the shareholders quite extensive rights to access information and materials related to the company and its activities.

> In German joint stock companies the right to information is connected to the general meeting of shareholders, where the management board is required to provide the shareholders with information and materials related to the issues on the agenda of the meeting or otherwise relevant for evaluating such issues (AktG § 131.1). The management is not required to provide the shareholders with access to the company's accounts or other documents.[149] In German limited liability companies, on the other hand, the management is required to provide each shareholder with information on issues related to the company at the shareholder's request and to allow each shareholder to review the company's accounts and other documents (GmbHG § 51a.1). Under the Finnish company law shareholders should be provided access to proposed resolutions and the annual reports not later than a week before the meeting (OYL § 5:21.1). The board and the general director also have an obligation to answer to shareholder inquiries related to the matters on the agenda of the meeting (OYL § 5:25.1).[150] The shareholders are however not provided access to the company's documents in the same extent as in Russian companies. In Sweden, on the other hand, the shareholders of companies with 10 or less shareholders are granted access to the company's accounts and other documents pertaining to the company's operations in the extent necessary for evaluating the company's finances and results or a matter on the agenda of a general meeting of shareholders (ABL § 7:36.1). The board and the general director should further provide such documents to the shareholders at their request (ABL § 7:36.1).[151]

[148] FCSM Code Chapter 7 Section 3.1.1, paragraph 2.
[149] See Chapter 2.1.3 for an account of the management board's reporting duty towards the board.
[150] HE 109/2005 vp pp. 73, 75. See Mähönen & Villa 2006b pp. 108-109, 115-118.
[151] Prop. 2004/05:85 p. 607. Prop. 1997/98:99 pp. 113-114. A similar shareholder right to information existed in the Finnish company law earlier to provide shareholders of small companies access to information. The rule was, however, considered insignificant, as well as problematic, since companies with less than 10 shareholders were not necessarily always small companies (See HE 109/2005 vp p. 75).

3. THE BOARD OF DIRECTORS

3.1. Duties and Responsibilities

The board of directors – or the supervisory board as it is also referred to in the law – is responsible for the general management of the company's activities in the extent such responsibilities are not assigned to the general meeting of shareholders (LJSC § 64.1.1). The Law on Limited Liability Companies does not charge the board with any particular function, but stipulates instead that the charter should set forth the board's function and competence (LLLC § 33.2.2). The board is optional in limited liability companies and joint stock companies with less than 50 shareholders (CC § 103.2.1, LJSC § 64.1.2, LLLC § 32.2.1). If the board is not established in a joint stock company, the shareholders are required to specify the governing body responsible for convening the general meeting of shareholders and for preparing its agenda in the charter (LJSC § 64.1.2).[152]

> A similar management structure including a voluntary board of directors and a mandatory executive management is found in German limited liability companies (GmbHG § 6.1, GmbHG § 52.1). In German limited liability companies the charter should set forth rules on establishing the board, as well as provisions on its composition and competence. If the charter lacks such rules and provisions, the relevant provisions of the *Aktiengesetz* should be applied (GmbhG § 52.1). In German joint stock companies the supervisory board is mandatory (AktG § 95.1). The board has however traditionally not been a particularly strong governing body in relation to the management board in German joint stock companies.[153] In other jurisdictions the board is often mandatory while appointing the general director may be optional. For example in Finland and Sweden the board, which is a mandatory governing body, may appoint a general director for the company to manage the company's day-to-day operations (OYL § 6:1.1, OYL § 6:20.1, ABL § 8:27.1).[154]

The main function of the board of directors is to supervise the company's activities and its management and to prevent and recognize abusive management behavior, such as abusive related party and major transactions. The board should further determine and develop the company's priority directions and strategies and ensure that the company's activities are carried out efficiently. It should also function as a link between the shareholders and the management, protect shareholder rights and interests and ensure that shareholder decisions are implemented appropriately. The board should further develop processes and policies necessary for ensuring the profitability, competitiveness and financial stability of the

[152] See Shitkina 2007 pp. 330-331. Kashanina 2010 p. 468. RCGM 2004 Chapter 4 p. 10. Yudenkov &Mozolin 2010 pp. 132-133.
[153] See Leider 2010 pp. 115-117.
[154] See HE 109/2005 vp p. 78. Prop. 2004/05:85 p. 626.

company and perform evaluations of the company's and the management's performance. The board is thus charged with an essential assurance function with regard to safeguarding shareholder rights and interests and directing the company. The board is not entitled to represent or act on behalf of the company.[155]

Both the Law on Joint Stock Companies and the Law on Limited Liability Companies contain a list providing for issues belonging to the competence of the board of directors (LJSC § 65.1.2, LLLC § 32.2.1.1). In joint companies the list of issues is open and can be extended by the charter to other issues (LJSC § 65.1.2, item 18). In limited liability companies, however, the board's competence can only be extended by the charter to issues provided for by the law (LLLC § 32.2.1.1, item 11). The legislator has thus quite significantly restricted the shareholders' possibilities to adjust the board's competence in limited liability companies. It should, however, be noted that the responsibility to direct the company constitutes a rather abstract responsibility which can contain various responsibilities and authorities. Moreover, if the shareholders want to charge the board with the competence to approve some of the company's transactions, the shareholders can do this under the rules on major transactions.[156]

The company laws vest the board of directors with the authority to, amongst other things, determine the company's priority directions (in limited liability companies if provided for in the charter), to arrange and convene the general meeting of shareholders and approve its agenda, to appoint and remove the management, if assigned to its competence, to recommend to the shareholders a suitable compensation for the revision commission and the external auditor (in limited liability companies the board is authorized to appoint the external auditor and decide the auditor's compensation if provided for in the charter), to recommend a dividend for the shareholders (only in joint stock companies), to approve by-laws and other internal documents provided for by the law or the charter, to establish branches and representative offices, to approve major transactions when the value of the transaction is less than 50% of the balance sheet value of the company's assets and related party transactions when the value of the transaction is less than 2% of the balance sheet value of the company's assets and to decide on participation in and exit from other

[155] See Shitkina 2007 pp. 331-332. FCSM Code Chapter 3 Sections 1.1-1.4. Kashanina 2006 p. 423. RCGM 2004 Chapter 4 p. 14. Also OECD 2004 pp. 24-25.
[156] See Chapter 2.1.2 above.

commercial organizations, such as subsidiaries (LJSC § 65.1.2, items 1-4, 9-11, 13-16, 17.1, LLLC § 32.2.1.1, items 1-10).[157] In joint stock companies the board is explicitly prohibited from delegating its authorities to the executive management (LJCS § 65.2.1). To establish a similar prohibition in limited liability companies, the shareholders should include a provision thereof in the charter.

> In court practice a shareholder's claim to void the acquisition of the entire charter capital of another company executed by general director was not supported by the court when the general director had acquired the board's approval prior to concluding the transaction (FCC West-Siberian Circuit N A45-13825/2009, also FCC North-Western Circuit N A21-3998/2007 regarding the disposal of shares in a subsidiary). It could be appropriate, for the sake of clarity, to stipulate in the charter that the board also decides on the incorporation of any subsidiaries. The general director, on the other hand, is vested with the authority to appoint the subsidiary's board of directors and management unless otherwise provided for in the charter.[158]

The board should supervise the executive management and ensure that it functions efficiently. This responsibility is not, however, provided for in the company laws in any further extent than that the laws refer to the board also as the supervisory board. The supervisory function of the board is essential for the shareholders since they may themselves not have the possibility to engage in the company's and its management's activities in the necessary extent. The shareholders could, for sake of clarity, provide for the board's supervisory function in the charter. To provide the board with the necessary authority to supervise the management, the shareholders should vest the board with the authority to remove the executive management.[159] On the other hand, in smaller enterprises the board could report to a representative of the shareholders on any issues requiring removal of the management, after which the shareholders could take the actual decision for removing the management in an extraordinary general meeting of shareholders, if necessary. The board should also, according to the Russian Corporate Governance Code, ensure that the company has adequate and accurate procedures for internal control in place to ensure accurate implementation of the business plan.[160] The internal control function of the board is a specific responsibility of the board's audit committee.[161]

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[157] See Shitkina 2007 pp. 331-334. Kashanina 2010 pp. 474-475. Mogilevskiy 2010 pp. 322-326. Black & al. 1999 pp.389-390.
[158] See Chapter 2.1.1 above.
[159] FCSM Code Chapter 4 Section 1.4.1, paragraph 1-2.
[160] FCSM Code Chapter 3 Section 1.2.1, paragraph 1, Chapter 8 Section 1.2, paragraph 4. See Yeremichev 2010 pp . 185-187.
[161] See Chapter 4.1.1 below.

> In German joint stock and limited liability companies the supervisory board is explicitly charged with the function to supervise the management, and it is authorized to review the company's accounts and other documents, as well as other property of the company. The supervisory board also reviews and approves transactions that require its approval under the charter or a by-law established by the board (AktG § 111.1-4, GmbHG § 52.1).[162] In Finland the board of directors is responsible for governing the company and organizing the company's activities properly, as well as for ensuring that the company's accounting and financial administration is properly controlled (OYL § 6:2.1). The board is entitled to give binding instructions to the general director regarding the company's management (OYL § 6:17.1). The board is also authorized to resolve on its own discretion any matter being in the general director's competence (OYL § 6:7.1). The board may also revert to the general meeting of shareholders in a matter belonging to its own or the general director's competence to (OYL § 6:7.2). Moreover, the board of directors is entitled to represent the company and act on its behalf (OYL § 6:25.1).[163]

When setting the company's directions, the board should, according to the Russian Corporate Governance Code, base long-term objectives on the current market situation, the company's financial situation and other circumstances that affect or may affect the company and its business activities. The board should establish and evaluate these objectives annually in connection with the approval of the company's annual business plan, which should be prepared by the executive management for the board's approval.[164] To ensure that the directions and objectives established by the board are followed and attained, the code recommends to obligate the executive management to request board approval for non-standard transactions, i.e. transactions that do not fall within the framework of the business plan.[165] This obligation should be included in the company charter and relevant by-laws such as the General Director Policy.

The law charges the board with direct competence to approve major transactions when the value of the transaction exceeds 25% of the balance sheet value of the company's assets, unless the transaction requires shareholder approval, and to approve related party transactions when the value of the transactions is less than 2% of the balance sheet value of the company's assets. Since the law allows the shareholders to adjust the scope of transactions to which the rules on major transactions apply, the shareholders can make the thresholds applying to major transactions lower and thus require that the management obtains board approval for less valuable transactions. The shareholders may also define

[162] See GCGC 2010 Section 5.1.
[163] See HE 109/2005 vp pp. 79-80, 89. Kyläkallio & al. 2008 pp. 614-616, 684-685.
[164] FCSM Code Chapter 3 Section 1.1, paragraph 2. Yeremichev 2010 pp.184-185. Shitkina 2007 p. 334.
[165] FCSM Code Chapter 4 Section 1.2, paragraph 3. See RCGM 2004 Chapter 4 p. 13.

specific types of transactions that always require board approval regardless of the value of the transaction.[166]

It should be noted that in joint stock companies the board is only competent to adopt by-laws that according to the law do not require shareholder approval and that do not belong to the management's competence according to the company's charter (LJSC § 65.1.2, item 13). The board of directors is thus not authorized to adopt by-laws that relate to the activities of the company's governing bodies, since such by-laws require shareholder approval. It can, however, adopt any other by-laws as long as the charter has not assigned the approval of such by-laws to the management's competence.[167] In limited liability companies the charter can vest the board with the competence to adopt any given by-laws, since the law does not contain any restrictions to the board's competence to adopt by-laws and the shareholders are allowed to freely delegate the competence to adopt by-laws to the board (LLLC § 32.2.1.1, item 6, LLLC § 33.2.2).[168]

The shareholders may thus freely assign the approval of by-laws to either to the competence of the board of directors or the general governing meeting of shareholders in limited liability companies, while approval of by-laws, such as the General Director Policy, pertaining to the activities of the company's governing bodies, cannot be delegated to the board in joint stock companies. To ensure that the necessary corporate governance and internal control processes are in place, a shareholder could withhold the authority to adopt by-laws that relate to the company's management and reporting with the general meeting of shareholders, while approval of by-laws relating to internal control could be assigned to the board. The board can, of course, be charged with the responsibility to develop by-laws for the approval of the general meeting of shareholders, even if the board would not be authorized to adopt the by-laws.

To regulate board work, the shareholders may establish a by-law regulating the board's activities.[169] The by-law, called, for example, the Board of Directors Policy, should set forth more detailed rules for the board's activities, such as rules on meeting processes and

[166] See Chapter 2.1.2 above for more details.
[167] See Telyukina 2006 pp. 305-306, 408-409.
[168] See Mogilevskiy 2010 p. 325. Ignatova 2006 pp. 169-170.
[169] Kashanina 2010 p. 470. The by-law is provided for in the Law on Joint Stock Companies, but not referred to in the Law on Limited Liability Companies (LJSC § 68.1.1).

the frequency of meetings, on communication with other governing bodies, such as the management, the internal audit service and the auditors, on establishment of committees, on distribution of board work within the board and on other similar issues. The Board of Directors Policy could also provide for principles according to which the board should perform its duties and responsibilities.

3.2. Reporting Duties

The law does not set forth any particular reporting duties for the board. The board of directors is authorized to convene an extraordinary general meeting of shareholders at its own initiative (in limited liability companies this requires a charter provision), which it should do when the company's or the shareholders' interests require that such meeting is held to resolve timely matters (LJSC § 55.1.1, LLLC § 32.2.2.1, LLLC § 35.1.1). The board of directors should thus convene an extraordinary general meeting of shareholders if any issue that the general meeting of shareholders should resolve arises or if a matter for some other reason requires the shareholders' attention. If a shareholder wants to increase the information flow from the board of directors to the shareholder, the shareholder could include periodical reporting duties for the board in the charter and the Information Policy and the Board of Director's Policy. The reports could be provided by the chairman of the board to a representative of the shareholders.

3.3. Composition

3.3.1. Election

In joint stock companies the board of directors is elected by the general meeting of shareholders through cumulative voting (LJSC § 66.1.1, LJSC § 66.4.1)[170]. Shareholders having at least 2% of the company's voting shares are entitled to propose candidates to the board (LJSC § 53.1.1).[171] According to the Law on Limited Liability Companies, the order for electing the board should be set forth in the charter (LLLC § 32.2.1). The shareholders can thus charge the general meeting of shareholders with the authority to elect the board. On the other hand, since the law does not establish any particular rules for electing the

[170] In cumulative voting the number of votes of each shareholder is determined by multiplying the number of voting shares owned by the shareholder by the number of board members to be elected. Each shareholder is then entitled to freely distribute these votes on the candidates (LJSC § 66.4.2, see RCGM 2004 Chapter 4 pp. 26-29).
[171] See Shitkina 2007 pp. 337-338. Yeremichev & Pavlov 2010 pp. 184.

board, the charter could stipulate, for example, that each shareholder directly appoints one or more board members, i.e. without any election procedure, or provide for some other method for appointing the board. The charter should also specify ownership or other requirements, if any, that a shareholder should fulfill to acquire the right to nominate candidates to and participate in the election of the board.[172]

In both company forms the charter should specify the number of board members. If the number of board members is unspecified, the shareholders should decide the number of board members when electing the board. The law requires boards of joint stock companies to have at least five board members (LJSC § 66.3.1).[173] When determining the composition of the board, the shareholders should provide for a board structure that promotes efficient board work, constructive discussion and prompt and rational decision-making.[174] Only individuals can be elected to the board of a joint stock company, while shareholders cannot be elected (LJSC § 66.2.1). The Law on Limited Liability Companies does not restrict shareholders from being board members in limited liability companies and nor thus it, in fact, require them to be individuals.

In joint stock companies the board is elected until the following annual general meeting of shareholders. If the annual general meeting of shareholders is not held within the period specified in the law, the board loses its capacity to act, except for the capacity to prepare, convene and hold the annual meeting (LJSC § 66.1.1).[175] The term of office of a board member can only be terminated prematurely if the entire board is dismissed (LJSC § 66.1.3). In limited liability companies the charter should specify the term of the board (LLLC § 32.2.2). Contrary to the provisions applying to joint stock companies, the Law on Limited Liability Companies does not require the entire board to be dismissed simultaneously and thus allows to prematurely terminate the office of a particular board member, if required.[176]

[172] Mogilevskiy 2010 pp. 326-327.
[173] See Shitkina 2007 pp. 337. Mogilevskiy 2010 p. 327.
[174] FCSM Code Chapter 3 Section 2.1, paragraph 1, Section 2.1.4, paragraph 1.
[175] See Kashanina 2010 p. 471. Shitkina 2007 p. 337.
[176] See Mogilevskiy 2010 pp. 327, 329.

3.3.2. Executive and Independent Directors

The Russian Corporate Governance Code specifies three types of board members, namely executive, non-executive and independent directors.[177] Executive directors are board members that simultaneously hold a position in the company's management board. To secure the supervisory function of the board of directors, such board members can only constitute ¼ of the entire board (LJSC § 66.2.2, LLLC § 32.2.2).[178] The Russian Corporate Governance Code does not contain a definition of non-executive directors, but by comparing the requirements applying to executive and independent directors, non-executive directors should be board members that do not hold an executive position in the company, but have some other connection to its management, affiliates, personnel or business partners or that have some personal interest in the company's business that can influence the board member's judgment.[179]

The Russian Corporate Governance Code defines independent directors as board members that are capable of making uninfluenced decisions. The purpose of having independent directors in the board is to allow the board to make objective decisions. Hence, to ensure that independent directors contribute to objective decision-making, independent directors should not have any connections to the company, its management, officers or affiliates. Further, an independent director should not have been employed by the company during the previous three years, should not have entered into any commercial or other contracts with the company by which the board member receives more than 10% of the board member's annual income and should not have entered into any transactions, the value of which exceeds 10% of the value of the company's assets, with the company. Additionally, a board member that has served in the board for more than 7 years should not be considered independent. The Russian Corporate Governance Code recommends that ¼ of the board should comprise of independent directors.[180]

[177] FCSM Code Chapter 3 Section 2.2.1, paragraph 1. See Makarov 2005 pp. 234-236.
[178] Kashanina 2010 p. 471. Mogilevskiy 2010 p. 330. Yeremichev & Pavlov 2010 p. 187.
[179] FCSM Code Chapter 3 Section 2.2.1, paragraph 2. See RCGM Chapter 4 pp. 36-38.
[180] FCSM Code Chapter 3 Section 2.2.1, paragraph 2, Section 2.2.2, paragraphs 1-3, Section 2.2.3, paragraph 1. See Shitkina 2007 pp. 336-337. Makarov 2005 pp. 235-236. Yeremichev & Pavlov 2010 pp. 188-189. RCGM Chapter 4 pp. 36-38. In relation to related party transactions the Law on Joint Stock Companies defines an independent director as a board member that has not and whose close relative has not held a position in the company's management during the previous year and who is not affiliated to the company (LJSC § 83.3.2).

> The Council of Institutional Investors defines an independent director as a person whose only nontrivial professional, familial or financial connection to the company, its chairman, CEO or any other executive is the board member's directorship. The council further considers that an independent director is, as stated most simply, a board member whose directorship constitutes the board member's only connection to the company.[181] The aforementioned could also be applied as a simple guideline in Russian companies when considering requirements for independent directors.

If an independent director ceases to be independent due to any changes in the given circumstances, the board member should, according to the Russian Corporate Governance Code, inform the board of this with a detailed account of the current and changed circumstances. The board should then inform to the shareholders that the board member can no longer be considered an independent director.[182] Since these procedural rules do not follow from the law, the shareholders should include them in the charter or the Board of Directors Policy if they want to apply them.

Foreign enterprises investing into Russia by establishing local subsidiaries are likely to look for board members that strive to secure shareholder rights and interests. In these cases it is most relevant that the board members are independent from the executive management. They do not, however, necessarily need to be independent from the shareholders. According to *Hellevig*, who refers to the independent directors as professional directors, the independent directors should provide the owners professional and experienced insight in the business to help carry on the business in a transparent, efficient way and to create better results and shareholder value.[183] The board could of course also include completely independent directors which have special insight in the company's field of business to support the board, but the board should also have a sufficient number of members that safeguard the owner's interest.

3.3.3. Board Committees

Board committees are not provided for in the law. Boards are however recommended to establish board committees to permit the board to handle complex issues effectively by allowing the board members to focus on matters belonging to their field of expertise. This should result in the provision of detailed analysis and recommendations to the board. Committees may also allow the board to develop subject-specific expertise on the

[181] Council of Institutional Investors 2010 Section 7.2.
[182] FCSM Code Chapter 3 Section 2.2.4, paragraph 1.
[183] Hellevig 2004 p. 2.

company's operations, for example, in regards to financial reporting and internal control.[184] Board committees should hold preliminary discussions on matters being on the agenda of forthcoming board meetings and prepare recommendations on those matters to the board to allow the board to make informed decisions on the basis of adequate and accurate information.[185] Board committees also carry out support functions, such as collecting and preparing information, materials, drafts and recommendations for the board.[186]

The Russian Corporate Governance Code recommends companies to establish, amongst others, a strategic planning committee and an audit committee. The board may also establish other permanent or *ad hoc* board committees when necessary. Committees are expected to enhance the efficiency and quality of the board's activities and should facilitate the establishment of effective control mechanisms to supervise the executive management.[187] It should, however, be noted that a large number of committees may be difficult to manage and may cause fragmentation in the board.[188] Committees should therefore be established as the need for them arises. *Hellevig* advises boards to start by distributing the board's responsibilities between the board members instead of immediately establishing committees.[189]

The chairman of the board should nominate board members to board committees in accordance with their professional qualities, however, taking into account the opinions of the other board members.[190] The composition of each committee should correspond to the committee's tasks and responsibilities. As committee members are required to study timely matters in detail, board members should not partake in more than one committee. Committees may also hire experts to provide consultation for the committee on timely matters.[191] Board committee's should have a chairman, preferably an independent or non-executive director, who should ensure that the committee provides the board with objective recommendations on timely matters.[192]

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[184] RCGM 2004 Chapter 4 p. 44.
[185] FCSM Code Chapter 3 Section 4.7.1, paragraph 1. See Yeremichev & Pavlov 2010 p. 193. Makarov 2005 pp. 242-243.
[186] Shitkina 2007 p. 342.
[187] FCSM Code Chapter 3 Section 4.7.1, paragraphs 1-2.
[188] RCGM 2004 Chapter 4 p. 45.
[189] Hellevig 2004 p. 3.
[190] FCSM Code Chapter 3 Section 4.1.5, paragraph 1.
[191] FCSM Code Chapter 3 Section 4.7.2, paragraphs 2-4. See Yeremichev & Pavlov 2010 p. 194.
[192] FCSM Code Chapter 3 Section 4.7.3, paragraph 1. See Yeremichev & Pavlov 2010 p. 194.

Neither the company laws nor the Russian Corporate Governance Code contain any provisions regarding the decision-making procedures of board committees. In single-member board committees this should not be a problem, since the board member responsible for the particular board committee's function simply provides the board with the board member's recommendation for resolving the matter. Multi-member board committees may, however, experience problems with decision-making if no decision-making procedures are established in advance. In such committees decisions could be made by voting in the same way that the board makes decisions and the committee chairman could be granted the casting vote in case of a tie. It should be noted that the committees only make recommendations for the board's consideration and lack independent capacity to make decisions in matters pertaining to the board's area of competence.[193]

The Russian Corporate Governance Code recommends the board to adopt a by-law providing for the establishment and activity of board committees.[194] However, it could be appropriate to provide for board committees that the shareholders consider significant for supervisory and control purposes in the charter.[195] Alternatively, the board may be allowed to independently establish such committees that it considers relevant for the organization of its work. If the shareholders decide to provide for committees in the charter, the charter should set forth the mandatory committees that the board should establish, their composition (for example 1-3 members in smaller companies), the function and responsibilities of each committee, decision-making procedures, reporting duties and rights to request and review relevant information.[196] Further, the charter could provide for committee policies, such as the Audit Committee Policy and the Strategic Planning Committee Policy to provide for detailed rules on the activity of these committees. The by-laws could be adopted either by the general meeting of shareholders or the board. To make the procedure more flexible, the board – which should also have better possibilities to determine the necessary rules – could be authorized to adopt the committee by-laws.

[193] RCGM Chapter 4 p. 45.
[194] FCSM Code Chapter 3 Section 4.7.2, paragraph 1.
[195] See Yeremichev & Pavlov 2010 p. 193.
[196] See Yeremichev & Pavlov 2010 p. 193.

3.4. Board Meetings

In joint stock companies board meetings are convened by the chairman of the board on the chairman's own initiative or on the request of a board member. Also revision commission members, the auditor, the management and other parties specified in the charter are entitled to request board meetings (LJSC § 68.1.1). Shareholders are thus not by default entitled to convene board meetings. The Russian Corporate Governance Code recommends to grant shareholders holding at least 2% of the company's voting shares the right to convene board meetings.[197] In ordinary joint stock companies each shareholder could, however, be provided the right to convene board meetings. The procedure for convening board meetings should be set forth in the charter or a by-law, e.g. in the aforementioned Board of Directors Policy (LJSC § 68.1.1). In limited liability companies the right to convene board meetings and the procedure for convening and holding the board meetings should be set forth in the charter (LLLC § 32.2.1.2). The rules could be similar to the rules applicable in joint stock companies.[198]

In joint stock companies at least half of the board members should be present at a board meeting for the board to be competent to make decisions, but the charter can provide for stricter quorum rules (LJSC § 68.2.1). The charter or a by-law should specify the procedures related to holding board meetings and may allow the board to make decisions through absentee voting and allow board members to submit opinions to the board on the matters on the agenda if they are hindered to participate in the meeting (LJSC § 68.1.1). To avoid problems with quorum rules the charter should specify whether board members that have submitted opinions on the matters on the agenda to the board are taken in consideration when determining whether the quorum for making decisions is fulfilled. In limited liability companies quorum rules and meeting procedures should be provided for by the charter and the Board of Directors Policy, since the law does not regulate these issues (LLLC § 32.2.2).[199]

A board decision requires that a majority of the board members present at the meeting are in favor of the decision. The charter may, however, require that certain decisions are taken

[197] FCSM Code Chapter 3 Section 4.13, paragraphs 1-3.
[198] See Shitkina 2007 pp. 338-339. Yeremichev & Pavlov 2010 p. 191. Mogilevskiy 2010 p. 331.
[199] See Shitkina 2007 p. 339. Mogilevskiy 2010 p. 331-332.

by qualified majority or by unanimous decisions (LJSC § 68.3.1). Each board member has one untransferable vote (LJSC § 68.3.2, LJSC § 68.3.3). The charter may state that the chairman's vote constitutes a casting vote in a tie (LJSC § 68.3.3). In limited liability companies the above issues are not regulated in the law and should therefore be provided for in the charter (LLLC § 32.2.2).[200]

In joint stock companies the chairman of the board is responsible for organizing the board work, convening board meetings and seeing to that minutes of its meetings are prepared (LJSC § 67.2.1). The chairman should also establish the agenda of each board meeting and ensure that board members receive information and materials related to the issues on the agenda in a timely manner. The chairman should also strive to promote open discussion amongst the board members.[201] The chairman is further responsible for maintaining contacts with the other governing bodies on behalf of the board as well as for coordination and communication with the board committee chairmen.[202] The chairman also signs employment agreements with the general director and management board members on behalf of the company, if signing such agreements is assigned to the board's competence (LJSC § 69.3.2, LLLC § 40.1.2). The board members elect the chairman by a definite majority decision, unless otherwise specified in the charter (LJSC § 67.1.1). It should be noted that the general director cannot be elected as chairman of the board (LJSC 66.2.2, LLLC § 32.2.3). In limited liability companies the rules regarding the chairman of the board should be specified in the charter (LLLC § 32.2.2).[203] The chairman's responsibilities and other rules could be similar to the above-referenced rules applicable in joint stock companies, but the shareholders are allowed to freely adjust them.

The Law on Joint Stock Companies requires the board to prepare minutes of its meetings (LJSC § 68.4.1). The minutes should contain the time and place of the meeting, the names of the board members that attend the meeting, the agenda of the meeting and issues put to vote, as well as resolutions made at the meeting (LJSC § 68.4.3). Opinions of non-attending board members and voting ballots should be attached to the minutes.[204] The minutes should be prepared within 3 days from the meeting and should be signed by the

[200] See Shitkina 2007 pp. 339-340. Kashanina 2006 pp. 425-426. Mogilevskiy 2010 pp. 331-332.
[201] FCSM Code Chapter 3 Section 4.1.2, paragraph 1.
[202] FCSM Code Chapter 3 Section 4.1, paragraph 1, Section 4.1.4, paragraph 1, Section 4.1.5, paragraph 1.
[203] See RCGM 2004 Chapter 4 pp. 42-44. Shitkina 2007 pp. 340-341. Mogilevskiy 2010 pp. 330-331.
[204] FCSM Code Chapter 3 Section 4.16.1, paragraph 1.

chairman of the meeting who by signing the minutes confirms that the minutes are correct (LJSC § 68.4.2, LJSC § 68.4.4). The minutes should be distributed to all board members.[205] The law does not contain any provisions regarding the minutes of board meetings in relation to limited liability companies. To ensure that the board prepares appropriate minutes from its meetings, the above, or any other proper rules, should be included in the charter. Detailed requirements and provisions on the minutes could be included in the Board of Directors Policy both in joint stock companies and limited liability companies.[206]

[205] FCSM Code Chapter 3 Section 4.16.2, paragraph 1.
[206] See RCGM 2004 Chapter 4 pp. 58-59. Kashanina 2010 pp. 476-477. Mogilevskiy 2010 p. 333.

4. CONTROL INSTITUTIONS

4.1. The Audit Committee

4.1.1. Function and Responsibilities

The Russian Corporate Governance Code recommends the board to establish a separate board committee to ensure efficient and direct control of the company's activities and compliance with the business plan – the audit committee.[207] The audit committee is responsible for the board's supervisory and control function and should ensure direct and actual participation of the board in the supervision and control of the company's finances and activities. The audit committee should provide accurate and complete information to the board on the company's finances and activities to allow the board to control the implementation of the company's business plan and to ensure that efficient processes for internal control are in place.[208] The main function of the audit committee is thus to oversee the implementation of the business plan approved by the board and to ensure that effective means for internal control are in place, as well as to provide the board with information on the company's finances and operations.

> For comparison, EC Directive 2006/43/EC on statutory audits applying to so-called public-interest entities within the European Community, i.e. entities that are of significant public relevance owing to the nature of their business or their size, charges the audit committee with the following responsibilities:
> - To monitor the financial reporting process;
> - To monitor the effectiveness of the company's internal control and internal audit where applicable, as well as risk management systems;
> - To monitor the statutory audit of the annual and consolidated accounts;
> - To review and monitor the independence of the statutory auditor or audit firm.
>
> The board is required to base its proposal for an auditor on the audit committee's recommendation. The auditor is required to report on key matters related to the audit and on weaknesses in the internal control systems related to financial reporting to the audit committee.[209]

The Russian Corporate Governance Code charges the audit committee with the responsibility to, amongst other things, control the company's finances and activities, especially the implementation of the business plan, to evaluate and discuss timely matters in its remit before board meetings and to prepare recommendations for the board on those

[207] FCSM Code Chapter 8 Section 1.1.2, paragraph 2.
[208] FCSM Code Chapter 3 Section 4.9, paragraph 1. See Makarov 2005 p. 272.
[209] EC Directive 2006/43/EC Article 41 Sections 2-4. See Werlauff 2003 pp. 394, 559 for an overview of board committee and audit committee practices in the EC (however pertaining to the time before the directive was adopted).

matters, to develop internal control processes together with the management and the internal audit service, to monitor the efficiency of internal control processes and to prepare proposals for their improvement, to supervise and control the internal audit service's activity, to prepare recommendations on approval of non-standard operations for the board, to report on violations and omissions to the board and the revision commission, to recommend an external auditor for the board and to maintain communications with the external auditor and the revision commission.[210]

The audit committee is thus primarily responsible for overseeing to company's activities and ensuring that effective internal control processes are in place. When the agenda of a forthcoming board meeting contains issues relating to the audit committee' responsibilities, the audit committee should review these issues and prepare proposals for their resolution to the board. The audit committee should continuously evaluate the efficiency of internal control processes and develop proposals for the board for their improvement if necessary. When the audit committee evaluates the company's internal control processes the audit committee should cooperate with the executive management and take in consideration the management's opinions in the extent possible. The audit committee should, however, remain in charge of the process as the management, in essence, constitutes the subject of internal control.

The audit committee should also supervise and monitor the activity of the internal audit service and review reports that the internal audit service prepares for the audit committee on the implementation of the business plan, compliance with internal control procedures, and on non-standard operations.[211] The employment agreement of the internal audit service's employees should be signed by the chairman of the audit committee.[212] The audit committee should further provide reports to the board of directors on violations and omissions detected by the internal audit service. Reports on violations and omissions should contain comprehensive information on the violation or omission, including the names of the people or parties that committed the violation or omission and the circumstances under which they were committed. The audit committee may

[210] FCSM Code Chapter 3 Section 4.9, paragraph 3, Chapter 8, Section 1.1.2, paragraphs 2-3, Section 1.2, paragraph 2, 5, Section 1.4, paragraph 3, Section 2.2.3, paragraph 1, Section 2.3.2, paragraph 1. See RCGM 2004 Chapter 4 p. 46, Chapter 14 p. 72. Makarov 2005 p. 272. Yeremichev & Pavlov 2010 p. 194.
[211] FCSM Code Chapter 8 Section 1.4, paragraph 2, Section 2.2.2, paragraph 4, Section 2.1.2, paragraph 2.
[212] FCSM Code Chapter 8 Section 1.3.5, paragraph 2.

simultaneously propose measures to the board for preventing similar violations or omissions in the future.[213] Further, the audit committee should propose for the board an external auditor and interact with the auditor and the revision commission on behalf of the board.

> The UK Corporate Governance Code and the UK Guidance on Audit Committees establish certain other responsibilities that could be assigned to the audit committee's responsibilities also in Russia. The audit committee should, according to the aforementioned codifications:
>
> - Monitor the integrity of financial statements and review significant financial judgments contained in them;[214]
> - Review significant accounting policies and their accuracy, any changes to them and the clarity and completeness of disclosures contained in the financial statements.[215]
> - Ensure that arrangements by which staff of the company may, in confidence, raise concerns about possible inadequacies in matters of financial reporting or other similar matters are in place, as well as that arrangements for the proportionate and independent investigation of such matters exist;[216]
> - Ensure that the internal auditor has direct access to the board chairman and to the audit committee, review and evaluate the annual internal audit work plan, review reports on the results of the internal auditor's work on a periodic basis, review and monitor the management's responsiveness to the internal auditor's findings and recommendations, and hold meetings with the head of internal audit at least once a year without the presence of management.[217]
>
> It is also recommended that the audit committee is provided with resources to hire independent legal, accounting or other advice when it reasonable believes it is necessary to do so.[218] Assigning the above-referenced responsibilities to the Russian audit committee could increase transparency, improve reporting procedures and accounting policies, enhance detection of violations and omissions, and improve the results of the internal audit service.

To perform its responsibilities the audit committee needs information on the company's activities and finances. The Russian Corporate Governance Code stipulates that each member of the audit committee should be provided unlimited access to all information and documentation concerning the company and its activities. When necessary the audit committee may be assisted in the collection of information by the internal audit service. Needed information should also be provided by the executives and employees of the company and by the company's external auditor at request. For ensuring that the audit committee has complete and correct information on the company's finances and business activities, the chief internal audit officer should report on the implementation of the business plan and of any deviations thereof at the meetings of the audit committee. If

[213] FCSM Code Chapter 8 Section 2.3.2, paragraph 1.
[214] FRC 2010 Section C.3.2.
[215] FRC 2008 Section 4.2.
[216] FRC 2010 Section C.3.4.
[217] FRC 2008 Section 4.15.
[218] FRC 2008, Section 2.11, Section 2.14.

necessary, the meetings of the audit committee should be attended by the external auditor and officers whose presence is necessary for resolving timely matters.[219]

The company's officers should also be under an obligation to provide requested documents and information to the audit committee. The Russian Corporate Governance Code stipulates that the chief internal audit officer, the executives and officers of the company and its auditor should report directly at the meetings of the audit committee with respect to the implementation of the business plan, compliance with internal control procedures and on non-standard operations.[220] Also the company's revision commission should provide the audit committee with complete information on its activity and on current audits.[221] It is particularly important that the executive management and heads of accounting departments are imposed an obligation to provide requested information to the audit committee if the company lacks an internal audit service, as these officers should have the most comprehensive information on the company's finances and business activity.

The audit committee should be vested with corresponding authorities to allow the audit committee to perform the above-referenced responsibilities, including the authority to supervise the internal audit service and to request reports on its activities and to communicate with the external auditor and the revision commission. The charter should provide the audit committee with the necessary authorities. It should also provide for the audit committee's function and responsibilities, composition, decision-making procedures and reporting duties. The charter could also provide for an Audit Committee Policy, containing detailed rules on the audit committee's activity such as rules on convening and holding meetings, reporting procedures and provisions on the content of reports, as well as on other relevant issues.

4.1.2. Reporting

The audit committee reports to the board. It should meet before each board meeting to discuss the matters on the agenda of the board meeting that relate to the audit committee's

[219] FCSM Code Chapter 8 Section 2.3.1, paragraphs 1-3. See RCGM 2004 Chapter 14 p. 75. Makarov 2005 p. 273.
[220] FCSM Code Chapter 8 Section 1.4, paragraph 2.
[221] FCSM Code Chapter 8 Section 3.1.6, paragraph 1.

responsibilities and provide advice to the board on resolving those matters.[222] Audit committee meetings should be held sufficiently in advance of board meetings to allow the other board members to familiarize themselves with the materials and information provided by the audit committee.[223]

> According to the UK Corporate Governance Code and the UK Guidance on Audit Committees, the audit committee should be devoted a separate chapter in the annual reports for describing its work and the manner in which it has discharged its responsibilities. The purpose of this is to "put the spotlight" on the audit committee and to give it an authority that it might otherwise lack. The audit committee section should include, amongst other things, a summary of the role of the audit committee, the names and qualifications of all members of the audit committee, the number of audit committee meetings and a report on the manner in which the audit committee has discharged its responsibilities.[224] A similar section devoted to the audit committee in Russian annual reports could enhance the audit committee's possibilities to reach shareholders with information and to communicate possible complications it has incurred in its activity. In the UK the chairman of the audit committee is also expected to attend the annual general meeting of shareholders to answer questions on the aforementioned report and on any matters within the audit committee's remit.[225] Such possibility could also in Russia enhance communication of internal control related matters to owners and would provide the audit committee a possibility to draw the attention of shareholders to risks it has identified.

The audit committee should forward information on omissions and violations committed in the company's business activities to the board. Such issues should be reported to the board periodically. It should also be distributed to the revision commission. The report on omissions and violations should contain complete information on the parties that committed the violations and omissions and of the circumstances under which the omissions or violations were committed. The audit committee may include proposals for preventing such omissions and violations in the report.[226] The audit committee should also after the internal audit service's preliminary evaluation of non-standard operations review the transaction and prepare a statement for the board of directors.[227] Any opinions on particular transactions provided by the audit committee should take in consideration commercial and other risks and corporate governance aspects.[228]

[222] FCSM Code, Chapter 8, Section 1.4, paragraph 3.
[223] See FRC 2008 Section 2.8.
[224] FRC 2010 Section C.3.3. FRC 2008 Section 1.6, Section 5.2.
[225] FRC 2008 Section 5.3.
[226] FCSM Code Chapter 8 Section 2.3.2, paragraph 1. See RCGM 2004 Chapter 14 p. 75.
[227] FCSM Code Chapter 8 Section 2.2.2, paragraph 4.
[228] FCSM Code Chapter 8 Section 2.3.2, paragraph 2.

4.1.3. Composition

The audit committee may comprise of one or more board members. According to the Russian Corporate Governance Code the composition of a board committee should in general be based on its function and enable it to carry out its responsibilities effectively.[229] When determining the composition of the audit committee the given circumstances should thus be taken into consideration. The composition of the audit committee should allow efficient supervision of the company's finances and activities.[230] The composition may vary according to the size, complexity and risk profile of the company and its organization.[231] The audit committee may enroll experts with professional skills required for performance of the audit committee's responsibilities.[232] These experts do, however, not make actual members of the audit committee, but only assist the audit committee in the performance of its responsibilities. The audit committee meetings may also be attended by revision commission members or the external auditor, if necessary.[233] It should, however, be in the audit committee's discretion to invite non-audit committee members to audit committee meetings.[234]

The Russian Corporate Governance Code recommends appointing only independent directors to the audit committee to ensure due and necessary objectivity in the audit committee's activities. If it is not possible to include only independent directors in the audit committee, then the audit committee should be chaired by an independent director while the other members should be non-executive directors.[235] Thus, if the company's board includes executive directors, these should not be appointed to the audit committee. Independent directors guarantee the audit committee independence from the company and its organization and management, which is essential for the performance of the audit committee's functions.

> The UK Corporate Governance Code recommends the audit committee to include two members in smaller companies, while audit committees of larger companies should have at least three members. The directors should be independent. The chairman of the board may

[229] FSCM Code Chapter 3 Section 4.7.2, paragraph 2.
[230] FCSM Code Chapter 8 Section 1.3, paragraph 1.
[231] See FRC 2008 Section 1.3.
[232] FSCM Code Chapter 3 Section 4.7.2, paragraph 4. See RCGM 2004 Chapter 14 p. 75.
[233] RCGM 2004 Chapter 14 p. 74.
[234] See FRC 2008 Section 2.7.
[235] FCSM Code Chapter 8 Section 1.3.1, paragraph 1. See RCGM 2004 Chapter 14 p. 74. Makarov 2005 pp. 272-273.

also be a member, but may not be the chairman of the audit committee.[236] The EC Directive 2006/43/EC on statutory audits requires the audit committee to be composed of independent directors, of which at least one should have competence in accounting or auditing.[237]

Smaller companies tend to have smaller boards. In Russia this applies in particular to limited liability companies where the law does not set forth a minimum number of board members. These companies may therefore consider it more appropriate to appoint a certain board member to be responsible for the function of the audit committee, i.e. to maintain control over the company's business operations and develop internal control functions, instead of appointing a multi-member audit committee. The board can gradually develop board procedures as experience is gained.[238]

The audit committee should meet on a regular basis. The Russian Corporate Governance Code recommends the audit committee to meat at least monthly. It should always meet before a board meeting, if the agenda of the board meeting contains any matters related to the audit committee's responsibilities.[239] The frequency of meetings and their timing however essentially depend on the circumstances at hand. The audit committee should meet as often as performing its functions require.

It may be burdensome and costly for the audit committee members to attend meetings on a monthly basis.[240] According to the UK Guidance on Audit Committees there should be as many meetings as the audit committee's role and responsibilities require, however not less than three meetings during the year. The timing of the meetings should preferably coincide with key dates within the financial reporting and audit cycle.[241] In view the above, it could be more appropriate also for Russian audit committees to meet when required, and not necessarily on a monthly basis, unless it is necessary for the audit committee to meet on a monthly basis.

4.2. The Internal Audit Service

4.2.1. Function and Responsibilities

To implement an efficient internal control system, the Russian Corporate Governance Code recommends companies to establish the internal audit service to perform continuous internal supervision of the company's activities independently from the executive

[236] FRC 2010 Section C.3.1.
[237] EC Directive 2006/43/EC Article 41 Section 1.
[238] See Hellevig 2004 p. 3.
[239] FCSM Code Chapter 8 Section 1.4, paragraphs 1, 3.
[240] See RCGM 2004 Chapter 14 p. 75.
[241] FRC 2008 Section 2.6.

management. The company laws do not contain provisions related to the internal audit service. The shareholders or the board may therefore specify the function, responsibilities and composition, as well as other relevant matters concerning the internal audit service, as they deem most appropriate.

> The OECD Principles on Corporate Governance note that oversight of the internal control systems covering financial reporting, use of company assets and guarding against abusive related party transactions can be assigned by the board to an internal auditor (i.e. the internal audit service) which should be guaranteed direct access to the board or its audit committee to ensure the integrity of its reports.[242] The definition of an internal auditor's function developed by the Institute of Internal Auditors describes the internal auditor's function as "… an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."[243]

The Russian Corporate Governance Code charges the internal audit service with the responsibility to perform continuous internal control of the company's finances and activities, to review transactions and related documents to ensure that the transactions conform with the business plan and the company's charter and by-laws, to provide reports on violations and omissions to the audit committee, to report on non-standard transactions to the audit committee and to conduct preliminary evaluations on such transactions, to assist the audit committee in collecting information on timely issues, to participate in and to provide information to audit committee meetings, and to participate in the development of internal control systems.[244] The internal audit service thus operates on a daily basis to ensure that the company's transactions and other activities comply with the law, the charter and the by-laws, as well as with other relevant regulation. It is also expected to provide reports to the audit committee and to assist the audit committee with collecting information on timely issues.

> For comparison, the International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors charge the internal audit service with the responsibility to evaluate the effectiveness and efficiency of internal control systems and to promote continuous improvement, in particular regarding reliability and integrity of financial and operational information, effectiveness and efficiency of operations, safeguarding of assets and compliance with laws, regulations and contracts.[245]

[242] OECD 2004 p. 62.
[243] IIA 2010a.
[244] FCSM Code Chapter 1 Section 7.2, paragraph 1, Chapter 8 Section 1.1.1, paragraph 5, Section 1.2, paragraph 2, Sections 2.1.1-2.1.2, Section 2.2.2, paragraph 4, Section 2.3.1, paragraphs 2-3. See RCGM 2004 Chapter 14 p. 83.
[245] IIA 2010b Section 2130, Section 2130.A1.

The internal audit service should be vested with the authority to request necessary information, including documents and other relevant materials, from the management and other officers and employees of the company. Correspondingly, the executives and other officers and employees should have an obligation to provide the relevant information and documents to the internal audit service in a timely manner. The company's executives, officers and other employees should also present documents and materials required for evaluating transactions within reasonable time after execution of each transaction. The shareholders may include the obligation to disclose and provide information to the internal audit service in the charter, while more specific rules related to the duty to provide information could be included in the relevant by-law.

It is particularly important that that the internal audit service monitors that the management complies with the charter and by-laws adopted by the shareholders and the board, if the company lacks a business plan in accordance with which the management should conduct the company's activities. The internal audit service should ensure that the management does not exceed its authorities established in the law, the charter and the by-laws and that necessary shareholder and board approvals are obtained when required. The internal audit service should also supervise compliance with the rules on related party transactions and ensure that the general director and management board members provide information on their affiliates according to the law, in particular of companies in which they own 20% of the shares or in which they hold management positions, such as board membership. The internal audit services control function should thus together with adequate reporting enhance shareholder control in relation to the company's activities and its assets and improve supervision of the management.

The Russian Corporate Governance Code recommends the board to adopt a by-law for specifying the structure and composition of the internal audit service, whereas the procedure for appointing the employees of the internal audit service should be provided for in the charter.[246] It could, however, be more appropriate to include the most fundamental provisions concerning the internal audit service in the charter. The charter could, in turn, provide for a by-law regulating the internal audit service's activities, called, for example,

[246] FCSM Code Chapter 8 Section 1.1.1, paragraph 5. See Shitkina 2007 pp. 367, 370-371.

the Internal Audit Policy, which the general meeting of shareholders, or alternatively the board, should adopt to regulate the activities of the internal audit service in detail. In this case the charter should specify the function and remit of the internal audit service, its structure and composition, reporting duties and accountability, its right to request and review information, and the governing body entitled to elect and dismiss the chief internal audit officer and other members. The Internal Audit Policy should, in turn, contain detailed provisions on the manner in which the internal audit service should perform its responsibilities, the frequency and content of its reports, eligibility criteria for its members and other similar issues.

To be able to appropriately perform its functions the internal audit service should be independent from the management. If a sufficient degree of independence is unguaranteed, the internal audit service may be hindered to function and perform its duties and responsibilities by the executive management, whose conduct the internal audit service monitors.[247]

> According to the Institute of Internal Auditors, independence is the freedom from conditions that threaten the ability of the internal auditor to carry out its responsibilities in an unbiased manner.[248] The internal auditor should be organizationally independent and should be free from any interference in its work. The internal auditor should be allowed to determine the scope of its work, perform assignments and communicate results without interference from the executive management.[249]

The Russian Corporate Governance Code recommends internal control systems to be developed by the executives jointly with the internal audit service and the audit committee.[250] Taking in consideration that the executive management constitutes, in essence, the subject of the supervision and control performed and maintained by the internal audit service, it could be more appropriate to charge the internal audit service with the responsibility to develop the internal control systems for the audit committee's and the board's approval, however, taking into consideration the management's opinions.

[247] FCSM Code Chapter 8 Section 1.3.5, paragraph 1.
[248] IIA 2010b Section 1100.
[249] IIA 2010b Section 1110, Section 1110.A1, Section 1111.
[250] FCSM Code Chapter 8 Section 1.2, paragraph 1.

4.2.2. Reporting

The internal audit service reports to the audit committee to which it is accountable. If the board lacks an audit committee, the internal audit service reports directly to the board.[251] The chief internal audit officer should provide reports regarding the implementation of and compliance with the business plan and internal control systems, as well as on non-standard transactions, at audit committee meetings.[252] The internal audit service should also report on violations and omissions discovered in the company's business operations to the audit committee. The Russian Corporate Governance Code recommends that violations and omissions are collected and then reported to the audit committee at one occasion.[253] However, to avert possible damage or harm to the company that delays in the provision of reports could cause, the internal audit service should be authorized to report single violations or omissions to the audit committee. For this purpose the audit committee should ensure that the chief internal audit officer has direct access to the chairman of the audit committee.

The internal audit service reports and advices the audit committee and the board on non-standard transactions after having conducted a preliminary evaluation of the transaction in question.[254] The internal audit service further plays an important role in collecting adequate and complete information on timely matters for the audit committee.[255]

> The Institute of Internal Auditors divides the internal auditor's reporting duties into functional and administrative reporting. The above described duties of the internal audit service would constitute functional reporting, while administrative reporting would comprise communication with the company's management, necessary for the performance of the day-to-day activities of the internal audit service.[256]

The Russian Corporate Governance Code does not take in consideration that a company may lack a board of directors, as it is primarily directed to open joint stock companies. It contains therefore no recommendation on to whom the internal audit service should report if the company lacks a board. As the internal audit service should be kept independent from the executive management, it should not report to the executives. Instead, the internal

[251] FCSM Code Chapter 8 Section 1.1.2, paragraph 3.
[252] FCSM Code Chapter 8 Section 1.4, paragraph 2. See RCGM 2004 Chapter 14 p. 84.
[253] FCSM Code Chapter 8 Section 2.1.2, paragraph 2.
[254] FCSM Code Chapter 8 Section 2.2.2, paragraph 4.
[255] FCSM Code Chapter 8 Section 2.3.1, paragraph 2.
[256] IIA 2002 Section 1.

audit service could report to a representative of the shareholders, for example, to the chairman of the general meeting of shareholders, or if the general director is its chairman, another representative determined by the shareholders. The chairman or the representative should then maintain communications with the chief internal audit officer between the shareholders meetings.

4.2.3. Composition

According to the Russian Corporate Governance Code, the internal audit service constitutes a department of the company including a chief internal audit officer and subordinate employees. The internal audit service is not a collective body such as the board, and should not apply collective decision-making procedures. As chief of the internal audit service the chief internal audit officer makes the necessary decisions. When determining the internal audit service's composition and size, the given circumstances should be taken into consideration. Particular attention should be paid to the size and complexity of the company, its organization and activities. The chosen composition should allow the internal audit service to efficiently perform its function. In smaller companies it should thus be sufficient to have a smaller internal audit service, while bigger companies with more complex operations and a bigger organization should require a bigger internal audit service.

> According to the Guidance on Audit Committees, the need for an internal auditor may vary depending on company specific factors such as the scale, diversity and complexity of the company's activities and the number of employees, as well as cost vs. benefit estimations.[257] The same factors should affect the composition of the internal audit service in Russian companies.

The employees of the internal audit service should have the education and work experience required for performing the responsibilities of the internal audit service. According to the Russian Corporate Governance Code, the members of the internal audit service should have knowledge in accounting and financial reporting. Preferably, the chief internal audit officer and 2/3 of the personnel should have a higher degree in finance or law and at least 5 years of work experience in similar positions.[258] Any conflicts of interest should be reviewed before hiring an employee to a position in the internal audit service.[259]

[257] FRC 2008 Section 4.10. Also FRC 2010 Section C.3.5.
[258] FCSM Code Chapter 8 Section 1.3.2, paragraph 2.
[259] FCSM Code Chapter 8 Section 1.3.3, paragraph 1.

For increasing the independence of the internal audit service, the employment agreement of the chief internal audit officer should be signed by the chairman of the board on behalf of the company, and the employment agreements of the other employees of the internal audit service should be signed by the chairman of the audit committee, notwithstanding that employment agreements of personnel are usually signed by the general director or heads of departments.[260] If the company lacks a board, the employment agreement of the chief internal audit officer could be signed by the chairman of the general meeting of shareholders on behalf of the company. Shareholders should also consider authorizing the board and the audit committee to manage procedures related to hiring and removing the chief internal audit officer. The term of office of the chief internal audit officer and the employees of the internal audit service should be set forth in their employment agreements.

A shareholder does not necessarily need to establish a separate department for performance of internal control functions in the Russian subsidiary. Instead, the function of the internal audit service could be performed by a single controller. If skillful controllers are available, a foreign investor could consider appointing a controller from its own organization to perform internal control functions in the Russian subsidiary. The controller would not necessary need to have such skills that, for example, an auditor has, but should instead be able to recognize signs or indications of abuse.[261] Local professionals could be hired to assist the controller in performing the functions of the internal audit service, if necessary. Appointing a controller from the won organization should ensure receipt of comprehensive and unbiased reports on the subsidiaries activities. On the other hand, if the internal audit service constitutes a bigger department of the company, the controller could also be placed to work amongst the other employees of the internal audit service as a subordinate to the local chief internal audit officer. In this case the foreign controller could be assigned the responsibility to maintain communications and report to the audit committee or the foreign shareholder.

[260] FCSM Code Chapter 8 Section 1.3.5, paragraph 2. Also FRC 2008 Section 4.14.
[261] See Blumme & al. 2005 p. 115.

4.3. The Revision Commission

4.3.1. Function and Responsibilities

The revision commission is mandatory in joint stock companies (LJSC § 85.1.1).[262] The charter should specify the revision commission's authorities if its competence is extended beyond the matters assigned to it in the law and its activities should be regulated by a by-law approved by the general meeting of shareholders (LJSC § 85.2.1, LJSC § 85.2.2).[263] The revision commission is mandatory in limited liability companies only if the company has more than 15 shareholders (LLLC § 32.6.1). The charter may, however, provide for the appointment of a revision commission in limited liability companies with less shareholders. The charter and by-laws should determine the procedures according to which the revision commission should perform its responsibilities (LLLC § 47.4.1).[264] According to the Russian Corporate Governance Code the internal policy regulating the revision commission's activity could be an Audit Policy.[265]

The revision commission is responsible for reviewing the financial and business operations of the company (LJSC § 85.1.1, LLLC § 47.1.1).[266] The revision commission should ensure that the company's activities are carried out in accordance with the law, the charter, by-laws and other instruments that regulate its activities and should, in particular, review bank transactions, credits and loans, expenses, cash registers and currency and other operations undertaken during the period subject to review.[267] The revision commission should conduct a review of the company's financial and business operations at least on an annual basis, since the annual meeting of shareholders must not approve the annual reports before they have been reviewed and approved by the revision commission (LJSC § 88.3.1, LLLC § 47.3.1).[268]

> A similar revision commission is not provided for in the German, Finnish or Swedish company laws. It seems that the revision could be a successor of the revision committee – the *Kontrolno-Revisionnoe Upravlenie* – of the former Ministry of Finance that during the

[262] See Shitkina 2007 p. 367.
[263] See Telyukina 2006 pp. 587-588.
[264] See Mogilevskiy 2010 pp. 380-381. Ignatova 2006 p. 166.
[265] FCSM Code Chapter 8 Section 3.1.3, paragraph 3.
[266] See Telyukina 2006 p. 586. Mogilevskiy 2010 p. 381. Ignatova 2006 p. 203.
[267] Kashanina 2010 p. 508.
[268] See Mogilevskiy 2010 p. 381. RCGM 2004 Chapter 14 p. 55.

> Soviet era performed financial control in Soviet enterprises by inspecting their financial activities and transactions.[269]

Other functions and responsibilities of the revision commission should be determined in the charter (LJSC § 85.2.1, LLLC § 47.4.1). Such additional functions and responsibilities could comprise reviewing the implementation of and adherence with credit and debt policies, compliance with expense policies and cash registers and adherence with budgets, prices paid for materials and services and reviewing contracts and claims.[270] The shareholders can utilize the charter and a by-law, for example, the Audit Policy, to provide for any other duties and responsibilities that they want the revision commission to perform. Ensuring compliance with the rules on major and related party transactions could be emphasized in the charter.

In joint stock companies the revision commission performs its reviews and audits in the form of ordinary and extraordinary audits. Ordinary audits are performed annually, while extraordinary audits are performed when required. Extraordinary audits may be initiated by the revision commission, the general meeting of shareholders, the board, or shareholders that hold at least 10% of the shares in the company (LJSC § 85.3.1).[271] Extraordinary audits of the revision commission may comprise, for example, audits of particular transactions.[272] In limited liability companies the revision commission is authorized to conduct an audit of the company's business operations any time it deems such audit necessary (LLLC § 47.2.1).[273] The law does not provide the shareholders or the board a right to require the revision commission to perform an extraordinary audit in limited liability companies. The charter could, however, provide for such right.

In joint stock companies the revision commission is entitled to convene an extraordinary general meeting of shareholders, as well as board meetings (LJSC § 55.1.1, LJSC § 85.5.1, LJSC § 68.1.1).[274] The revision commission of a limited liability company is entitled to convene an extraordinary meeting of shareholders (LLLC § 35.2.1). It should convene the extraordinary meeting of shareholders under the circumstances specified in the charter or

[269] See Chapter 1.1 above.
[270] Shitkina 2007 pp. 369-370. See Mogilevskiy 2010 p. 382. RCGM 2004 Chapter 14 p. 56.
[271] See Telyukina 2006 pp. 588-589.
[272] FCSM Code Chapter 8 Section 3.1.1, paragraph 1.
[273] See Mogilevskiy 2010 p. 381.
[274] See Telyukina 2006 p. 589-590.

under any other circumstances when required for securing the interest of the company or its shareholders (LLLC § 35.1.1).[275] As the law does not grant the revision commission a right to convene a board meeting in limited liability companies, the shareholders could grant this right to the revision commission by including a provision thereof in the charter.

To perform its duties and responsibilities the revision commission the company laws grant the revision commission the right to access company documents and other information related to the company's activities. Company officers have an obligation to present documents related to the company's finances and activities to the revision commission at its request (LJSC § 85.4.1, LLLC § 47.2.1).[276] The revision commission is thus secured a right to necessary information in the law. In joint stock companies the revision commission is separately entitled to request protocols from management board meetings and information on related party transactions (LJSC § 70.2.2, LJSC § 82.1.1).

The obligation to establish a revision commission and to hire an auditor – which can be the case in bigger companies – is criticized by *Black & al.*, who states that any sufficient grounds for requiring companies to elect both a revision commission and appoint an auditor do not exist owing to the similarity of their functions.[277] It should, however be noted that even if the function of the revision commission and the external auditor are similar, the shareholders may adjust the function and responsibilities of the revision commission in a more comprehensive manner than they may adjust the responsibilities of the external auditor, which activities are more strictly determined in the law. However, it may be difficult to find an appropriate function and place for the revision commission in the company's internal control structure, particularly if the company has hired an external auditor to review the annual reports, taking in consideration that the company may also have an audit committee and an internal audit service that perform internal control functions in the company.

[275] See Ignatova 2006 p. 174.
[276] See Telyukina 2006 p. 589. Kashanina 2006 p. 455. Mogilevskiy 2010 p. 381.
[277] Black & al. 1999 pp. 490-491.

4.3.2. Reporting

The law does not state to which company body the revision commission should provide its reports. The Russian Corporate Governance Code states that results of extraordinary audits should be presented to the audit committee and the body or party that initiated the extraordinary audit.[278] The aforementioned code further recommends the revision commission to work in close cooperation with the audit committee and provide it with full information on its activities, audits and conclusions.[279] Audit reports should further be provided to the general meeting of shareholders, but before that the board and the general director should be provided an opportunity to view the reports.[280]

In regards to joint stock companies the law contains a separate provision according to which the annual report of the revision commission should contain a statement on the accuracy of the annual reports and accounts, as well as information on violations of accounting or financial reporting procedures or of relevant laws and regulations, committed in the company's activities (LJSC § 87.1.1). In limited liability companies the charter should require that such omissions and violations are reported by the revision commission in its audit reports.[281] If the revision commission conducts a separate review of a particular transaction, the revision commission should make a statement on the transaction. The revision commission may accompany its report with proposals for removing any discrepancies revealed in the review.[282]

The Russian Corporate Governance Code recommends to provide for audit periods and terms in the by-laws to avoid unnecessary delays. The code recommends that extraordinary audits should be initiated within 30 days from receipt of the request and that they should be completed within 90 days.[283] Audits of the annual reports should be finalized in sufficient time before the annual general meeting of shareholders to allow the board to review the revision commission's report before sending it to the shareholders in due time before the meeting.

[278] FCSM Code Chapter 8 Section 3.1.5, paragraph 1.
[279] FCSM Code Chapter 8 Section 3.1.6, paragraph 1.
[280] Kashanina 2010 p. 508.
[281] Mogilevskiy 2010 p. 383.
[282] Kashanina 2010 p. 508.
[283] FCSM Code Chapter 8 Section 3.1.3, paragraphs 1-2.

4.3.3. Composition

The revision commission is elected by the general meeting of shareholders by simple majority (LJSC § 85.1.1, LJSC § 49.2.1, LLLC § 47.1.1, LLLC § 37.8.3). The authority to elect the revision commission may not be delegated to the board of directors or the management (LJSC § 48.2.1, LJSC § 48.2.2, LLLC § 33.2.2).[284] Further, any shareholders holding a position in the board or management of the company may not participate in the election of the revision commission members in joint stock companies (LJSC § 85.6.2). Such prohibition does not apply to limited liability companies, but the shareholders may establish a similar prohibition by including a provision thereof in the charter.[285]

Neither of the Russian company laws determines the composition of the revision commission. By virtue of the wording of the laws the revision commission may either constitute a collective body or a sole auditor (LJSC § 85.1.1, LLLC § 47.1.1). As the law does not specify the number of members of the revision commission the shareholders should specify this in the charter (LLLC § 47.1.2).[286] Usually the revision commission comprises three members.[287] Revision commission members may not simultaneously hold positions in the board of directors or any other positions in the company's management (LJSC § 85.6.1, LLLC § 32.6.3). The general director, management board members and other members may thus not be appointed to the revision commission.[288] This is natural taking in consideration that the revision commission's function is, in essence, to review the conduct of the management. In a multi-member revision commission the members may elect a chairman to organize the work of the revision commission.[289]

The company laws do not determine the term of office of the revision commission. According to the Federal Commission for Securities Markets, the term of office of the revision commission should be considered to continue until the following annual meeting of shareholders in joint stock companies, since election of the revision commission is one of the matters that the annual meeting of shareholders should attend to according to the law

[284] See Shitkina 2007 p. 368. Telyukina 2006 p. 586. Mogilevskiy 2010 p. 380.
[285] Mogilevskiy 2010 p. 381.
[286] See RCGM 2004 Chapter 14 p. 54.
[287] Kashanina 2010 p. 507. Mogilevskiy 2010 p. 380.
[288] See Telyukina 2006 p. 590. Mogilevskiy 2010 pp. 380-381.
[289] Kashanina 2006 p. 454. Mogilevskiy 2010 p. 382.

(LJSC § 47.2.1).[290] In limited liability companies the term of office of the members of the revision commission should be determined in the company charter (LLLC § 47.1.1). Usually the revision commission members are appointed for a term of 3-5 years.[291] The shareholders are entitled terminate the office of the revision commission at its discretion in (LJSC § 48.1.1 p. 9, LLLC § 33.2.1, p. 5). Grounds for such termination could be set forth in the charter.[292]

The law does not provide decision-making procedures for the revision commission. Those should be specified in the charter (LLLC § 47.4.1, LJSC § 85.2.2). According to the Russian Corporate Governance Code, the procedures should provide for efficient supervision of the financial and business operations of the company.[293] The code further states that the revision commission should adopt decisions through majority votes and that it is competent to make decisions when at least half of its members are present at its meetings.[294] The revision commission should also prepare protocols from its meetings containing adopted decisions and results of audits. The protocol should be signed by each revision commission member that attends the meeting. Any dissenting opinions should be attached to the protocol.[295]

A foreign shareholder should thus, if the Russian subsidiary is established as a joint stock company, elect a revision commission which may consist of one or more members, whereas this is not required in limited liability companies. Taking into consideration that the remit of the revision commission seems to overlap with the responsibilities of the audit committee, the internal audit service and the external auditor, there may not be much reason to establish the revision commission unless required by the law. However, if an external auditor is not hired to review the annual reports, a professional review of the annual financial reports prepared by the revision commission would provide the board and the shareholders with a second opinion on the reports.

[290] Letter N IK-07/883 Section 2. See Shitkina 2007 p. 368.
[291] Mogilevskiy 2010 p. 380.
[292] Ignatova 2006 p. 203.
[293] FCSM Code Chapter 8 Section 3.1, paragraph 1.
[294] FCSM Code Chapter 8 Section 3.1.2, paragraphs 1-2.
[295] FCSM Code Chapter 8 Section 3.1.4, paragraph 1. See Kashanina 2006 p. 455. See Moglievksiy 2010 p. 383.

4.4. The Auditor

4.4.1. Function and Responsibilities

External audits are mandatory for company's engaged in certain types of commercial activity and for all joint stock companies and limited liability companies when the size of their operations exceed certain financial threshold values. The audit conducted by the external auditor differs from the audit conducted by the revision commission in that the external auditor independently chooses the form and method for conducting the audit and in that the audit conducted by the external auditor is independent from any third parties, including the shareholders.[296]

By virtue of the Law on Auditing, an external audit should be conducted in open joint stock companies, credit and insurance institutions and investment funds and similar businesses specified in the law, or if the company's turnover exceeds 50 million rubles or if the value of the company's assets exceeds 20 million rubles per the annual reports of the previous financial year (LA § 5.1.1). External audits are thus mandatory in ordinary joint stock companies and limited liability companies only if the above-referenced thresholds are exceeded.

It should be noted that ordinary limited liability companies that have less than 15 shareholders and whose assets or turnover does not exceed the above thresholds are not required to appoint neither a revision commission nor an external auditor. This means that the annual reports may be approved by the shareholders without their accuracy having been reviewed by a financial professional, unless the shareholders appoint an auditor or arrange for the review of the annual reports by other means. Under these circumstances possible mistakes or omissions in the financial reports, as well as possible abusive transactions undertaken by the management may go unnoticed by the shareholders. The shareholders should therefore preferably appoint an auditor to review the annual reports before their approval also in smaller limited liability companies. In joint stock companies, on the other hand, it is mandatory to appoint a revision commission to review the annual reports before the shareholders approve them. It could, however, be appropriate to appoint

[296] Kashanina 2010 pp. 510-511.

an external auditor to conduct an independent review of the annual reports also in smaller joint stock companies.

In joint stock companies the auditor should review the company's finances and business operations, whereas the auditor of a limited liability company should review the annual financial reports and the current state of affairs of the company (LJCS § 86.1.1, LLLC § 48.1.1).[297] The audit carried out by the auditor is contrary to the revision commission's revision an external function. The auditor should conduct an independent review of the accounts and annual reports of the reviewed organization to verify their accuracy (LA § 1.3.1). The objective of the audit is thus to form an opinion on the accuracy of the annual reports and to verify that the company's accounts have been prepared in accordance with the law. According to the Accounting Law, the accounts should allow the reader to make correct conclusions of the company's result and state of financial affairs and to use the information as decision-making basis (AL § 1.3.1).[298] When conducting the audit the auditor should scrutinize the annual reports in order to identify any errors, malpractice and violations of the law.[299]

The auditor needs information on the company's activities and finances to conduct the audit. The auditor is therefore granted certain authorities in relation to the company and its staff. The auditor is thus authorized to request and review documents related to the company's business operations, as well as to request oral and written explanations on any matters related to conducting the audit from the company's officers (LA § 13.1.1, items 2-3).[300] The company laws also separately grant the auditor access to the charter (LJSC § 11.4.1, LLLC § 12.3.1). The Law on Joint Stock Companies further authorize the auditor to request minutes of management board meetings and to request information on related parties in regards to related party transactions (LJSC § 70.2.2, LJSC § 82.1.1).[301] If the auditor is not granted access to relevant documents or is not provided requested information, the auditor is entitled to refrain from conducting the audit and preparing the audit report (LA § 13.1.1, item 4).[302]

[297] See Telyukina 2006 p. 592. Mogilevskiy 2010 p. 383.
[298] See Nikitin 2002 p. 13. Shitkina 2007 p. 371.
[299] FCSM Code Chapter 8 Section 4.1.3, paragraph 1.
[300] See Nikitin 2002 pp. 27-28.
[301] See RCGM 2004 Chapter 14 p. 63.
[302] See Nikitin 2002 pp. 27.

The auditor is entitled to convene an extraordinary meeting of shareholders at its discretion (LJSC § 55.1.1, LLLC § 35.2.1). In joint stock companies the auditor is further entitled to convene board meetings and management board meetings, whereas this right should be provided for in the charter in limited liability companies (LJSC § 55.1.1, LJSC § 68.1.1).

4.4.2. Audit Report

The auditor shall prepare an audit report after having reviewed the annual reports and the accounts. The audit report should be presented to the shareholders before they approve the annual reports. The Russian Corporate Governance Code recommends that the audit report is submitted to the audit committee for review before its submission to the shareholders to ensure that the auditor conducted the audit in accordance with statutory requirements and that all timely matters were attended to in the audit.[303]

The audit report constitutes an official statement prepared for the parties having an interest in the annual reports and accounts of the audited organization and should contain the auditor's statement regarding the accuracy of the information contained in the annual reports and the company's accounts (LA § 6.1.1). In regards to joint stock companies the law contains a separate provision according to which the audit report prepared by the auditor should contain a statement on the accuracy of the information contained in the annual reports and other financial documents, as well as information on violations of accounting or financial reporting procedures and relevant laws and regulations in the company's business operations (LJSC § 87.1.1).[304]

The audit report should contain the title "Audit report", the names of the recipients, requisites of the reviewed company (business name, registration number, place of residence, etc.), requisites of the auditor (business name, registration number, place of residence, member organization, registration number, etc.), requisites of the reviewed annual reports and the audit period, information on the audit procedure, the auditor's statement on the accuracy of the annual reports and circumstances that substantially affect or may affect the accuracy of the information contained in the report, information on any

[303] FCSM Code Chapter 8 Section 4.1.5, paragraphs 1-2.
[304] See Shitkina 2007 pp. 372-373. RCGM 2004 Chapter 14 p. 68.

violations or omissions revealed in the audit and the date of the audit report (LA § 6.2.1, LJSC § 87.1.1). According to the Russian Corporate Governance Code the audit report should disclose any discrepancies in the company's financial documents and violations committed in the company's business activities. The auditor should also require the company to correct any erroneous information included in the annual reports.[305] The auditor should participate in the annual meeting of shareholders to answer any questions related to the audit report.[306]

In view of the above, hiring a qualified auditor to review the company's annual reports and business operations could constitute a useful tool for confirming the accuracy of the information included in the annual reports by the executive management.

4.4.3. Composition

The auditor is elected by the general meeting of shareholders (LJSC § 86.2.1, LJSC § 48.1.1, item 10, LLLC § 48.1.1, LLLC § 33.2.1, item 10). The auditor should be elected on the basis of the audit committee's and the board's recommendation.[307] A by-law, for example the Audit Policy, could set forth selection criteria and other guidelines for selecting the company's auditor. The auditor may be an individual or a legal entity with a license to perform audit services (LA § 3.1.1, LA § 4.1.1). According to the Russian Corporate Governance Code, professional competence, honesty and responsibility should be the guiding principles of independent auditors. Auditors should be impartial and independent in relation to the company's management and officers, board members and shareholders (LA § 8.1.1).[308] It should be noted that the Russian law provides for so-called self-regulating audit organizations, which are non-commercial audit organizations established for the purpose of promoting appropriate and professional auditing (LA § 17.1.1).

[305] FCSM Code Chapter 8 Section 4.1.1, paragraph 2, Section 4.1.4, paragraph 2.
[306] FCSM Code Chapter 8 Section 4.1.2, paragraph 1.
[307] FCSM Code Chapter 3 Section 4.9, paragraph 2.
[308] Decree N 696 Standard N 1 Section 3. FCSM Code Chapter 8 Section 4.1.1, paragraphs 3-4.

5. CORPORATE GOVERNANCE INSTRUMENTS

5.1. The Charter

The charter constitutes the company's founding document (CC § 98.3.1, LJSC § 11.1.1, CC § 89.3.1, LLLC § 12.1.1).[309] It is registered with the state registration authority – the federal tax authorities[310] – in connection with the establishment and registration of the company (LSR § 12.1.1). Any subsequent amendments require registration with the state registration authority (LJSC § 14.1.1, LLLC § 12.4.2.).[311] The charter is above the by-laws in the hierarchy of internal company documents. In case of a conflict between the charter and a by-law, the charter prevails and the provisions of the charter are applied instead of the provisions of the conflicting by-law.[312] The charter constitutes an essential instrument in corporate governance, since it is the instrument in which the corporate governance structure of the company is manifested. It also provides for the distribution of authorities and responsibilities between the governing bodies and provides information on this distribution to third parties.[313] Only the general meeting of shareholders is competent to amend the charter (LJSC § 12.1.1, LLLC § 12.4.1).[314]

The company laws and the Civil Code set forth certain mandatory content for the charter. The laws require that the charter includes, amongst certain other things, the full and short name of the company (in joint stock companies also an indication of whether the company is a private or public joint stock company), the company's address, the charter capital, the rights and obligations of the shareholders, information on branches and representative offices, the procedure for storing company documents and materials and the procedure for providing them to shareholders (only limited liability companies), the structure and competence of the company's governing bodies and relevant decision-making rules, including decisions requiring qualified majority or unanimous consent and matters belonging to the exclusive competence of the general meeting of shareholders, and the procedure for preparing and holding the general meeting of shareholders (only joint stock

[309] See Yudenkov & Mozolin 2010 pp. 113, 125.
[310] Decree N 506 Section 1.2.
[311] See Shitkina 2007 p. 51. Ignatova 2006 pp. 70-73. RCGM 2004 Chapter 3 p. 45.
[312] Shitkina 2007 pp. 50-51.
[313] See RCGM 2004 Chapter 3 p. 45.
[314] In joint stock companies the board may make changes to the charter under the circumstances specified in the law, relating mainly to decreasing and increasing the charter capital under specific circumstances and to the establishment of branches and representative offices (LJSC § 12.2.2-6).

companies) and other information provided for in the company laws (CC § 52.2.1, CC § 98.3.2, LJSC § 11.3.1, CC § 89.3.2, LLLC § 12.2.1).[315]

> In some jurisdictions, for example, in Finland, the charter is required to specify the company's field of business (OYL § 2:3.1). The field of business can, however, be indicated broadly as "all legitimate business activity" or in a similar general manner, which does not restrict or determine the company's business.[316] If a specific field of business has been indicated in the charter, the general director's right to represent the company, including the right of other directors and representatives to represent the company, can be restricted in the charter to transactions belonging to the indicated field of activity (OYL § 6:27.2). However, differently from the general rule, a transaction concluded by the general director or another representative beyond such restrictions is not considered unbinding for the company on the basis of registration of the charter with the trade register and the following presumption that the other party should have known of the restriction. Instead, it is required that the other party actually under the circumstances should have known of the restriction (OYL § 6:28.2).[317] A similar requirement can be found in the German *Aktiengesetz*, which requires the charter to indicate the field of activity of the company, including products and goods that the company intends to produce or sell (AktG § 23.3). The charter of a German limited liability company should specify the company's field of activity (GmbHG § 3.1).

The charter thus contains basic information and rules related to the company. Including shareholder rights and obligations in the charter is relevant in particular for companies with several shareholders representing different parties, since the shareholders should agree on exit rules, preemptive rights, obligations to inform of share transfers, and other such rules, whereas it is not equally essential to describe extensive shareholder rights and obligations in companies with only one shareholder or a few shareholders from the same enterprise. The shareholders should also specify the company's management structure and the authorities and decision-making procedures, namely quorum and majority requirements for decision-making, if these differ from or are not provided for in the law. It is especially important that the shareholders state whether the company has established any of the optional governing bodies, i.e. the board of directors or the management board and the decisions they are competent to make.

Shareholders are also allowed to include other provisions in the charter as long as they do not conflict with the law (LJSC § 11.3.3, LLLC § 12.2.2). The shareholders can thus include restrictions to the general director's authorities, such as additional transactions to

[315] See Shitkina 2007 pp. 172-173. Ignatova 2006 pp. 70-71. Yudenkov & Mozolin 2010 pp. 76-77, 113-114, 125. RCGM 2004 Chapter 3 pp. 46-47.
[316] HE 109/2005 vp p. 44.
[317] HE 109/2005 vp p. 89. See EC Directive 2009/101/EC Article 10 Section 1.

which the rules on major transactions should apply in the charter or other adjustments of the general director's competence.[318] The charter should also contain provisions regulating the board of directors' activity and provide for the Board of Directors Policy and its relevant content.[319] The charter could also provide for board committees, such as the audit committee, that the board is required to establish to ensure efficient board work and control over the company's activities and provide for their main functions and responsibilities. The charter may provide for a specific committee by-law, such as the Audit Committee Policy, or state that the rules on committees are specified in the Board of Directors Policy.[320] Further, the charter should contain rules regulating the Management Board's activity if it is established, particularly rules related to its competence and composition, as well as provide for the Management Board Policy.[321] The charter should also specify whether the general meeting of shareholders or the board of directors appoint and remove the management[322] and whether the management can be transferred to a management company.[323]

In regards to internal control, the charter could set forth rules related to the Internal Audit Service, including particularly its function and duties and responsibilities, as well as provisions on the Internal Audit Policy.[324] Further, the charter should contain rules on the revision commission, particularly on its competence and composition (in limited liability companies only if the revision commission is established).[325]

To establish periodical reporting duties for the executive management and the board, the charter could provide for, for example, quarterly or other periodic reports that the management is required to provide to the board of directors or the shareholders on the company's activities and the main content and purpose of such reports, as well as on reports that the board should provide to the shareholders, whereas detailed requirements of the reports and the procedure for their provision could be set forth in the Information Policy adopted by the general meeting of shareholders, which would allow the

[318] See Chapter 2.1.2 above.
[319] See Chapter 3.1 above.
[320] See Chapters 3.1 and 4.1.1 above.
[321] See Chapter 2.1.3 above.
[322] See Chapter 2.1.4 above.
[323] See Chapters 2.1.1, 2.3.1 and 3.1 above.
[324] See Chapter 4.2.1 above.
[325] See Chapter 4.3 above.

shareholders to flexibly adjust the content of the reports when necessary.[326] Further the charter could allow the shareholders to specify additional information that the management should provide to the shareholders in connection with the general meeting of shareholders, as well as information that the shareholders should be provided access to at request, in the Information Policy.[327]

The company shall provide the charter, including any amendments to the charter, to each shareholder, the auditor and other parties within a reasonable time from receipt of the request for a fee not exceeding the cost of preparing the copies (LJSC § 11.4.1, LLLC § 12.3.1). In joint stock companies the charter should be provided within 7 days from receipt of the request, while the applicable term is 3 days in limited liability companies (LJSC § 91.2.1, LLLC § 50.4.1).[328] After registration of the charter, the charter is also available from the state registration authority (LSR § 6.1.1).

5.2. By-laws (Internal Documents)

Both the Law on Joint Stock Companies and the Law on Limited Liability Companies refer to by-laws – or "internal documents" – in which the company may provide for internal processes and rules for dealing with matters unregulated by the law or in regards to which the law provides dispositive rules. The purpose of the by-laws is to allow the company, in practice either the general meeting of shareholders or the board, to complement the company laws by adopting by-laws to regulate the company's organization and activities when necessary, taking into consideration the scope of the business, the structure of the organization, and other relevant issues.[329]

> The German *Aktiengesetz* does not refer to by-laws as consequently as the Russian company laws do, but it does, however, contain references to management board and supervisory board business directives in relation to specifying the management board's competence (AktG § 82.2).[330] The Swedish company law refers to certain written working orders and instructions that the board should prepare. The board should annually prepare a written working order for its work, if it has more than one member. The working order should provide for the distribution of the board work between the board members, the frequency of its meetings and the extent in which deputies should participate in the meetings (ABL § 8:6.1-2). It may also contain other relevant information and rules. The

[326] See Chapters 2.2 and Chapter 3.2 above.
[327] See Chapter 2.4 above.
[328] See RCGM 2004 Chapter 3 pp. 52-53.
[329] See Shitkina 2007 pp. 45-46. Makarov 2005 p. 33-34.
[330] See du Plessis & Saenger 2007 pp. 50-51 regarding the purpose of such business directives. Also GCGC 2010 Section 4.1.3, Section 4.2.1.

> board should also issue written instructions providing for reports and information that other company bodies should provide to the board to allow the board to continuously assess the company's financial situation. Such reporting system is, however, not required, if the reports would not, taking into consideration the size of the company, affect the board's possibilities to receive the necessary information in any significant extent (ABL § 8:5.1). The board is also required to prepare and issue written instructions providing for the distribution of duties and responsibilities between the board and the general director and other company bodies established by the board (ABL § 8:7.1).[331] The Finnish law does not contain references to similar by-laws or working orders. The general meeting of shareholders and the board can, however, adopt by-laws related to, for example, the order of holding shareholder and board meetings.[332]

Appropriately adopted by-laws are binding for the company's entire organization, including shareholders, governing bodies, divisions, officers, employees and others in the extent the by-law pertains to the rights and obligations of any of the aforementioned. By-laws adopted in accordance with the law are also binding for courts when resolving any internal disputes of the company, such as disputes between shareholders or shareholders and the management.[333] As mentioned above, if any provision of a by-law conflicts with the charter, the charter provision prevails.[334] Regulating the company's activities and other procedures in by-laws instead of the charter allows the company to flexibly amend relevant rules, since by-laws are not subject to state registration.[335] The company laws provide for certain by-laws, but companies are also allowed to adopt any other by-laws that are deemed necessary.[336]

In joint stock companies the general meeting of shareholders adopts by-laws that regulate the activities of the governing bodies (LJSC § 48.1.1, item 19). The general meeting of shareholders is specifically required by the law to adopt by-laws that regulate the activities of the management board and the revision commission (LJSC § 70.1.1, LJSC § 85.2.2). It should be noted that the shareholders may, however, only adopt by-laws proposed by the board, unless otherwise provided for in the charter (LJSC § 49.3.1). The board of directors is competent to adopt by-laws that according to the law do not require shareholder approval and which approval the charter has not assigned to the management's competence (LJSC § 65.1.2, item 13). Hence, in joint stock companies the general meeting of shareholders has the authority to adopt the by-laws related to the company's management,

[331] See Prop. 1997/98:99 p. 197-200. Prop 2004/05:85 pp. 618-619. Sandström 2007 pp. 213-215.
[332] Huttunen 1984 pp. 21-22.
[333] Shitkina 2007 pp. 48-49.
[334] Shitkina 2007 pp. 50.
[335] Makarov 2005 pp. 35.
[336] See Makarov 2005 p. 36. RCGM 2004 Chapter 3 p. 53.

while the board of directors is authorized to adopt by-laws that do not relate to the activities of the company's governing bodies.[337] The board should thus be authorized to adopt by-laws that relate to internal control, such as the Internal Audit Policy, but is not authorized to adopt, for example, the Board of Directors Policy or the General Director Policy.

The Law on Joint Stock Companies in many cases refers to a by-law by stating that the matter should be regulated either in the charter or in a by-law. This is the case, for example, in regards to the procedures related to convening and holding board meetings that should be provided for either in the charter or a by-law (LJSC § 68.1.1). In this case the law allows the shareholders to choose between including the necessary provisions in the charter or a by-law. On the other hand, in some cases the law requires that the relevant matter is regulated specifically in a by-law. This is the case in regards to, for example, the rules on the revision commission's activities that must be specified in a by-law approved by the general meeting of shareholders (LJSC § 85.2.2).[338]

In limited liability companies both the general meeting of shareholders and the board of directors are competent to adopt by-laws that regulate the internal activities of the company (LLLC § 33.2.1, item 8, LLLC § 32.2.1.1 item 6). Since the board's competence to adopt by-laws is not restricted and since adopting by-laws belongs to the general meeting of shareholders alternative competence, the approval of by-laws may be freely distributed between these governing bodies in the charter (LLLC § 32.2.1.1 item 6, LLLC § 33.2.2).[339] To ensure that the necessary corporate governance and internal control processes are in place, the shareholders could withhold the authority to adopt by-laws that relate to the company's management and reporting with the general meeting of shareholders, while approval of by-laws related to internal control could be assigned to the board.

The Law on Limited Liability Companies in many cases refers to by-laws by stating that a certain matter should be regulated in the charter and by-laws. This is the case, for example, regarding the rules pertaining to the general director's activities, in regards to which the

[337] See Telyukina 2006 pp. 305-306, 408-409.
[338] See Makarov 2005 pp. 35-36.
[339] See Mogilevskiy 2010 p. 325. Ignatova 2006 pp. 169-170.

rules should be included in the charter, by-laws and the general director's employment agreement (LLLC § 40.4.1). The same applies to the procedure for holding the general meeting of shareholders (LJSC § 37.1.1). In these cases the law seems to indicate that the relevant rules should be found in both the charter, by-laws and, in the former case, in the employment agreement. A more appropriate interpretation of the law would, however, be to consider that the law allows the shareholders to distribute the relevant rules between the charter and by-laws in the manner they deem most appropriate. To allow for flexibility, the charter should contain fundamental rules, while by-laws should contain the more detailed rules.

By-laws should be used to provide detailed rules and procedures on issues provided for in the charter, and under some circumstances, to regulate matters that are not regulated in the charter or the law. Preferably the charter should set forth the most relevant by-laws that the general meeting of shareholders and the board should adopt and the relevant content of the by-laws.[340] By regulating matters that the law does not require to be included in the charter in by-laws, the company can more flexibly and more time-efficiently change the company's internal processes, since the law does not require by-laws to be registered with the state registration authority.

> The following by-laws are provided for in this thesis: the Board of Directors Policy[341], the Audit Committee Policy[342], the Management Board Policy[343], the General Director Policy[344], the Information Policy[345], the Business Plan Policy[346], the Audit Policy[347], the Internal Audit Policy[348] and the Internal Control Policy, which could alternatively incorporate the Audit Committee Policy, the Audit Policy and the Internal Audit Policy into one by-law covering the company's internal control system.

5.3. The Business Plan

The company's business plan has a significant role in directing and overseeing the company's operations, according to the Russian Corporate Governance Code, which states

[340] See RCGM 2004 Chapter 3 p. 46.
[341] See Chapter 3.1 above.
[342] See Chapter 4.1.1.
[343] See Chapter 2.1.3
[344] See Chapter 2.1.1
[345] See Chapters 2.3, 2.4 and 3.2 above.
[346] See Chapter 5.3 below.
[347] See Chapter 4.3.1 and 4.4.3.
[348] See Chapter 4.2.1.

that the business plan constitutes the company's main financial document.[349] According to the aforementioned code, the board of directors should see to that the company has a business plan in place to ensure that the company's priority directions are followed and to ensure effective control over the company's finances and business operations.[350] Correspondingly, the executive management is required to follow the business plan when conducting the management of the company's operations.[351] The business plan, which should be prepared and approved on an annual basis, is thus a part of the oversight system that ensures continuous control over the company's operations and ensures that the company is managed toward its objectives.[352] The business plan is also considered to assist the company in developing strategies, saving costs and attracting business partners and investors.[353]

> Reference to a similar business plan cannot be found in the German, UK, Finnish or Swedish Corporate Governance Codes. The German Corporate Governance Code, however, requires the management board to coordinate the company's strategy with the supervisory board and to inform the supervisory board of any deviations from previously formulated plans and objectives.[354] The UK Corporate Governance Code states that the chairman of the board should discuss strategies with the company's major shareholders, but a particular business plan is not provided for.[355] It seems possible that the extensive business plan provided for in the Russian Corporate Governance Code could be a successor of the *Gosplan* which the central government prepared in the Soviet Union. For example *Kashanina* refers to earlier centralized state planning and its transfer to the companies themselves under the market economy, the transfer requiring the companies to independently prepare a business plan.[356]

The business plan should be approved by the board of directors.[357] The Russian Corporate Governance Code recommends that the management board prepares the business plan for the board.[358] If the company lacks a management board, the responsibility to prepare the business plan can be assigned to the general director, while larger companies could have a planning committee.[359] The Russian Corporate Governance Code further recommends to require that the business plan is approved by the board by a qualified 2/3 majority, since

[349] FCSM Code Chapter 8 Section 2.2.1, paragraph 1.
[350] FCSM Code Chapter 1 Section 3.1, paragraph 1, Chapter 3 Section 1.2.1, paragraph 1, Chapter 8 Section 1.1.1, paragraph 3.
[351] FCSM Code Chapter 1 Section 4.3, paragraph 1, Chapter 3 Section 1.2, paragraph 1.
[352] FCSM Code Chapter 1 Section 7.1, paragraph 1.
[353] Kashanina 2010 p. 456.
[354] GCGC 2010 Section 3.2, Section 3.4, paragraph 2.
[355] FRC 2010 Section E.1.1.
[356] Kashanina 2010 pp. 451-452.
[357] FCSM Code Chapter 8 Section 1.1.2, paragraph 1.
[358] FCSM Code Chapter 4 Section 1.1.2, paragraph 1.
[359] Kashanina 2010 pp. 452-453.

the business plan is of significant importance for the company.[360] Before approving the proposed business plan, the board should review it and when doing so take into account the current market situation, the company's financial standing and other issues that affect the company's finances and business operations.[361]

The business plan should budget expenses for each area of activity of the company and also allocate funds for covering these expenses. The business plan should include, in particular, chapters on production, marketing and investment efforts. The business plan should be accurate, but should leave room for the management to make necessary business decisions within the framework of the day-to-day operations.[362] The business plan is also considered an important document for evaluating the executive management's performance, since the performance of the management can be compared to the anticipated results provided for in the business plan.[363]

According to the Russian Corporate Governance Code the management should obtain board approval for non-standard transactions, i.e. transactions that are not provided for by the business plan.[364] According to the code, the charter and relevant by-laws should set forth the procedure for obtaining such approval.[365] Before a non-standard transaction is approved, the Internal Audit Service should analyze and evaluate the transaction, and, in particular, evaluate why the transaction was not originally provided for in the business plan and to what degree the transaction is necessary or beneficial for the company.[366] According to the aforementioned code, non-standard operations should be reviewed more strictly than other transactions, since they are in conflict with the company's main financial document.[367]

[360] FCSM Code Chapter 3 Section 4.15, paragraph 2.
[361] FCSM Code Chapter 3 Section 1.1, paragraphs 2-3.
[362] FCSM Code Chapter 3 Section 1.1, paragraph 3, Chapter 4 Section 1.2, paragraph 2. Also Kashanina 2010 pp. 454-456.
[363] FCSM Code Chapter 4 Section 1.2, paragraph 2.
[364] FCSM Code Chapter 4 Section 1.2, paragraph 2, Chapter 8, Section 2.2.1, paragraphs 1-2, Section 2.2.3, paragraph 1.
[365] FCSM Code Chapter 4 Section 1.2, paragraph 4, Chapter 8 Section 2.2.2, paragraph 1.
[366] FCSM Code Chapter 8 Section 2.2.2, paragraph 3.
[367] FCSM Code Chapter 8 Section 2.2.2, paragraph 2.

Within the board, the board's audit committee is responsible for ensuring efficient control over the implementation of the business plan.[368] The audit committee should see to that the board has information on the company's finances and business operations in the extent necessary for overseeing the implementation of the business plan.[369] Also the internal audit service plays an important role in monitoring the implementation of the business plan, since it should collect all documents pertaining to the company's business transactions from the management and verify that the transactions conform to the business plan.[370] The chief internal audit officer should report on the implementation of the business plan at each audit committee meeting.[371]

In view of the above, shareholders may utilize the business plan as a means for specifying a framework within which the general director should conduct the company's business operations. The business plan does not, however, allow the company or a shareholder to file a claim for voiding any non-standard transactions undertaken by the general director with third parties without obtaining prior approval. Such restrictions should be included in the charter.[372] However, the business plan could allow the shareholders to direct the company and its management and to evaluate the management's performance.

If the shareholders consider the business plan suitable for the purpose of directing the Russian subsidiary and its management, the shareholders could include provisions concerning the preparation and approval of the business plan in the charter. The charter may thus require the general director to prepare a draft business plan for the board's approval for a certain period and specify the main content of the business plan. Further, the charter could provide for a by-law, for example a Business Plan Policy regulating the process of preparing the business plan, such as the time frame within which the plan should be presented to the board, more detailed content of the business plan, the procedure for making changes to the business plan, the approval of non-standard transactions, as well as principles for their evaluation, and other relevant issues concerning the business plan.

[368] FCSM Code Chapter 8 Section 1.1.2, paragraph 2, Section 1.4, paragraph 2.
[369] FCSM Code Chapter 3 Section 4.9, paragraph 2.
[370] FCSM Code Chapter 8 Section 2.1.1, paragraph 1.
[371] FCSM Code Chapter 8 Section 2.3.1, paragraph 3.
[372] See Chapter 2.1.2 above.

5.4. Executive Agreements

5.4.1. The General Director Agreement

In Russia the agreement between the general director and the company is considered an employment agreement. The general director's employment agreement is not regulated in detail in the company laws. Nonetheless, both the Law on Joint Stock Companies and the Law on Limited Liability Companies state that rules on the general director's conduct also follow from the general director's employment agreement (LLLC § 40.4.1, LJSC § 69.3.2). The company laws thus give the general director's employment agreement a certain place in the corporate governance framework, since its provisions affect the general director's activities. The Labor Code contains general rules related to employment agreements and certain separate rules applying to executive agreements, including the general director's employment agreement.

Thus, the general director's employment agreement can be concluded for a fixed term on the basis of the parties' mutual agreement, regardless of that fixed-term agreements are otherwise allowed only under specific circumstances (LC § 59.2).[373] The term of employment can be set forth either in the charter or in the general director's employment agreement (LC § 275.1).[374] The general director is often elected for a period of 3 - 5 years, which is considered to be a sufficient time for the general director to become acquainted with the company's business and not to be constrained by short-term goals.[375] It is, however, of course also possible to conclude the agreement for an indefinite term.

The general director's employment agreement can also provide for a trial period, which can be up to six months compared to the general maximum term of three months (LC § 70.5). If the shareholders are unsatisfied with the general director's performance during the trial period, the shareholders can remove the general director without an obligation to pay a severance payment to the general director (LC § 71.2). In this case it is required that the general director is given a written notice including the reason for the failure of the trial period three days in advance of the termination of the employment agreement (LC §

[373] See Chikanova 2008 p. 212.
[374] See Myshko 2009 p. 367. Korshunova 2008 pp. 845-846.
[375] RCGM 2004 Chapter 5 p. 89.

70.1).[376] It is not sufficient to remove the general director on subjective or abstract reasons; the general director must have committed a factual omission or violation of regulations or performed the general director's responsibilities insufficiently.[377]

The Russian Corporate Governance Code recommends to include a list of the general director's rights and obligations in the general director's employment agreement.[378] These obligations would, however, be more in place in the General Director Policy, since including them in a by-law allows the general meeting of shareholders or the board to amend and specify the duties from time to time if required, as amending a by-law does not require the general director's consent.[379]

As a general rule, an employment agreement can be terminated, if the employee repeatedly fails to perform the employee's labor duties or commits a single severe violation of the employees labor duties or responsibilities (LC § 81.1, items 5-6). Removing the general director on the basis of continuous violations require that the general director has been given warnings and reprimands in accordance with the law and other regulations.[380] As severe violations qualify, for example, appearing intoxicated at work or disclosing commercial secrets.[381] The general director's employment agreement can further be terminated if the general director makes an unfounded decision which causes damage or harm to the company's assets or property (LC § 81.1, item 9). The decision should clearly be unfounded and should have caused harm or damage to the company's property.[382] The general director's employment agreement can also provide for other grounds on the basis of which the employer is entitled to terminate the employment agreement (LC § 81, item 13, LC § 178.1, item 3).[383] Such grounds could be, for example, failure to execute shareholder decisions or failure to perform the general director's duties efficiently and successfully on the basis of specified indicators.

[376] Chikanova 2008 p. 238-241.
[377] See Buyanova 2010 p. 177.
[378] FCSM Code Chapter 4 Section 2.2.2, paragraph 1. See RCGM 2004 Chapter 5 99-100 regarding content of the employment agreement.
[379] Hellevig 2010.
[380] Decree N 2 Section 33, paragraphs 1-2.
[381] See Decree N 2 Sections 42-43. Chikanova 2008 pp. 282-286.
[382] See Decree N 2 Section 48. Chikanova 2008 pp. 288.
[383] See Chikanova 2008 pp. 290. Dolinskaya 2006 pp. 553-554. FCSM Code Chapter 4 Section 2.2.2, paragraph 1.

The general director's employment agreement can also simply be terminated by a decision taken by the competent governing body, i.e. the general meeting of shareholders or the board of directors (LC § 278.1, item 2, LJSC § 69.4.1). In this case, however, the company has to pay a severance payment to the general director equal to no less than a three-month average salary, unless any of the above-referenced grounds are present that would allow the employer to terminate the agreement on the basis of the general director's misconduct (LC § 279.1).[384]

> In court practice a company has been obligated to pay a severance payment provided for in the employment agreement to the general director regardless of that the general director was removed on grounds that the general director failed to execute a board decision, since the employment agreement did not stipulate that the severance payment would be paid only in case the general director was removed without reason (Supreme Court N 5-V05-156).

The Russian Corporate Governance Code states that the employment agreement should require the general director or management board member to give prior notice of terminating the employment agreement.[385] Such notice is provided for in the Labor Code, according to which the general director is required to give written notice one month in advance of termination of the agreement (LC § 280.1).[386] According to the aforementioned code, the employment agreement should also include succession procedures and impose an obligation to refrain from disclosing any of the company's confidential information to third parties during their term of office and thereafter.[387] The succession procedures would however be more appropriate in the General Director Policy.

According to the Russian Corporate Governance Code, the employment agreement should also specify whether the general director is entitled to hold positions in other companies.[388] According to the Law on Joint Stock Companies, the general director and the management board members are allowed to hold positions in the management of other organizations only on the board's consent (LJSC § 69.3.4). The employment agreement could further specify whether the general director or a management board member is allowed to hold other positions in other organizations, such as positions in special-interest or business organizations. In regards to limited liability companies the question is not resolved in the

[384] See Dolinskaya 2006 pp. 556-558. Hellevig & Usov 2006 p. 39.
[385] FCSM Code Chapter 4 Section 2.2.2, paragraph 1.
[386] See Kostyan 2010 pp. 624-625.
[387] FCSM Code Chapter 4 Section 2.2.2, paragraph 1.
[388] FCSM Code Chapter 4 Section 2.2.2, paragraph 1.

law. The employment agreement should therefore regulate this issue. Further, the General Director Policy could set forth guidelines and principles for the general director regarding positions in other organizations.

The Russian Corporate Governance Code recommends that the board is charged with the authority to specify the terms and conditions of the general director's employment agreements.[389] However, if the general meeting of shareholders is, by virtue of the charter, competent to appoint and remove the general director, approval of the terms and conditions should accordingly be assigned to the general meeting of shareholders. The general director's employment agreement is signed in joint stock companies on behalf of the company by the chairman of the board of directors or a person authorized by the board (LJSC § 69.3.2). In limited liability companies the agreement is signed on behalf of the company by the chairman of the general meeting of shareholders or the chairman of the board, or a person authorized by them (LLLC § 40.1.2).

Since the general director's employment agreement constitutes only a part of the framework that regulates the general director's duties and responsibilities, the shareholders should include references to the charter and such by-laws that essentially pertain to the general director's activity in the general director's employment agreement to clarify that the general director shall follow the provisions of those other instructions when conducting the company's activities.

5.4.2. Management Board Member Agreements

The separate rules that are applicable to the general director's employment agreement under the Labor Code can be made applicable to the management board members by including a provision thereof in the company charter (LC § 281.1).[390] Such provision would thus enable the shareholders to apply a 6-month trial period for management board members and allow the shareholders or the board to remove management board members by a simple decision. It would also allow the shareholders or the board to include additional grounds for removal of the management board member. Without such provision

[389] FCSM Code Chapter 3 Section 1.4.3, paragraph 1.
[390] Chikanova 2008 p. 867.

in the charter the general rules of the Labor Code apply to the management board members' employment agreements.

6. CONCLUSIONS

6.1. Management and Shareholder Authorities

The general director of a Russian company has significant authorities in relation to the company and its assets. In both Russian company forms the strong position of the general director follows in particular from the fact that the general director is vested with the sole authority to represent the company. This authority cannot be restricted by the shareholders in the charter and nor can any other governing body be authorized to represent the company. Under the company laws of the two Scandinavian jurisdictions, Finland and Sweden that were reviewed in this context, also the board of directors' is vested with authority to represent the company. The general director is thus not provided a similar monopolistic position in regards to representing the company under the company laws of these jurisdictions as the general director is provided under the Russian company laws. Further, the Finnish and Swedish company laws provide for restricting the general director's authority to represent the company by means of the dual-signature system. A similar, unrestricted right to represent the company is, however, also granted to the general director under the German company laws.

The general director's and the management board's competence comprises decisions belonging to the company's day-to-day operations. If the management board is established, the distribution of authorities between the general director and the management board should be provided for in the charter. The Russian company laws do not provide the general meeting of shareholders or the board of directors with competence in matters belonging to the company's day-to-day operations. The management is thus provided comprehensive authorities to decide in matters related to these operations. The law, however, contains certain restrictions to the general director's competence, related to so-called major and related party transactions. According to the rules on major transactions, transactions, the value of which exceeds 25% of the company's balance sheet value require board approval or, if the company lacks a board, shareholder approval.

The rules on major transactions do, however, not apply to transactions related to the company's ordinary business operations, regardless of whether the value of the transaction would exceed the aforementioned threshold value, and hence do not restrict the general

director competence to execute any transactions related to the day-to-day operations. The general director is competent, for example, to take a loan, if even the value of the loan would exceed the aforementioned threshold value, if the loan is taken in relation to the company's day-to-day business operations, for example, for acquiring necessary raw materials or stock or for some other purpose related to the company's ordinary business operations. Hence, the rules on major transactions do not as such restrict the general director's authority to undertake transactions related to the company's ordinary business operations, regardless of how valuable or significant the transaction would be for the company.

The Finnish and Swedish laws restrict the general director's competence in a different manner, providing for an evaluation of the significance of the transaction in comparison to the type and size of the company's business, the term and duration of the transaction, and the transactions that the general director usually executes within the sphere of the company's day-to-day business operations. This solution for restricting the general director's competence, which does not include all transactions that are in some manner related to the company's ordinary business operations to the general director's competence, could be an alternative for the Russian system under which transactions are strictly divided into transactions that are related to or respectively unrelated to the company's ordinary business operations. The solution would allow an evaluation of the actual significance of the transaction for the company, acknowledging that also transactions related to the company's ordinary business operations can be significant for the company. In Russia this could improve shareholder control and supervision.

The company laws also limit the general director's competence to execute transactions with related parties. Thus, the general director is required to obtain board or shareholder approval when the general director or a relative or affiliate of the general director has an interest in the transaction. Such interest is considered to, by default, to exist if the general director or a relative of the general director is a party to the transaction, owns more than 20% of the charter capital of the other party of the transaction or if the aforementioned people hold a position in the management of the other party of the transaction. The law allows the shareholders to specify additional circumstances in the charter under which transactions should be considered related party transactions.

The shareholders competence, in turn, vests the shareholders with the authority to amend the charter, adopt by-laws in the extent not delegated to the board, elect and remove board members and the general director and management board members, unless the latter issue is delegated to the board, to approve major transactions and related party transactions in the extent not assigned to the board's competence and to decide on the distribution of dividend. Fundamental decisions related to the company and its management are thus assigned to the competence of the general meeting of shareholders. The shareholders' competence does not extend to the company's day-to-day operations and the shareholders do not have authority to represent the company. It may be mentioned that in certain other jurisdictions, such as Finland, the shareholders may by a unanimous decision undertake to resolve any matter belonging to the general director's or the board of directors' competence. Such authority could, especially in smaller Russian limited liability companies, provide the shareholders with more control and authority in relation to the management.

To increase the shareholders' authority in relation to the management and to shift the balance of powers towards the shareholders, the shareholders can establish restrictions to the management's competence. The general director's authority to represent the company cannot, however, be restricted. The restrictions to the management's competence can be established by lowering the threshold values applied to major transactions and/or by extending the rules on major transactions to certain types of transactions, such as loans or transactions related to real estate. Such restrictions should be entered in the charter. To file a claim for voiding a transaction executed by the general director in violation of such restrictions a shareholder is required to show that the shareholder suffered a loss or was caused damage by the transaction and that the other party knew or should have known of the restriction.

The management's competence can alternatively be restricted separately from the rules on major transactions by simply extending the competence of the general meeting of shareholders or the board of directors to certain transactions on the basis of the value or type of the transactions. In this case it should, however, be noted that the competence of the general meeting of shareholders cannot be extended in joint stock companies to other

issues than those provided for by the law. This also applies to the board of directors of a limited liability company. The claim for voiding a transaction taken beyond such restrictions to the general director's competence can also only be filed by the company, in practice its general director, whereas under the major transactions also a shareholder can file such claim.

Thus, to answer the question of how extensive authorities to decide in matters related to the company and its assets the law grans to the management in comparison to the authorities it grants to the shareholders, the answer should be that under the default rules the management's authorities are quite extensive in comparison to authorities of the general meeting of shareholders. To shift the balance of powers toward the shareholders, the law however allows the shareholders to establish restrictions to the management's competence. Hence, the Russian company laws should not be considered to grant the management an extraordinary strong position in the company in relation to the general meeting of shareholders.

6.2. The Asymmetry of Information

It was mentioned in the introduction that the asymmetry of information that usually prevails between the management and the shareholders makes it difficult for the shareholders to assure that the management acts solely in the company's and the shareholders' interest. To analyze in what degree such asymmetry can be expected in Russian companies, the management's reporting duties and the shareholders' right to information were studied above.

The analysis shows that the Russian company laws do not provide for other periodical reporting duties for the management toward the shareholders or the board than the annual reports. The management of a Russian company is thus not required by the law to report to the board or the shareholders of issues related to the company, except in connection with the general meeting of shareholders. For comparison, in German joint stock companies the management board is required to report to the supervisory board on the company's plans and strategies, its liquidity, on issues affecting the market and the company's market situation. Further, in Finland the general director is expected to, at the general director's own initiative, provide the board of directors with information that the board needs for

performing its duties and responsibilities. To remedy the lack of reporting duties, the shareholders of a Russian company can, however, establish such reporting duties for the management by including provisions thereof in the charter and by adopting an Information Policy providing for monthly, quarterly or other reports and the content of them.

On the other hand, despite that the law does not provide for management reporting duties, the shareholders are provided extensive rights to access the company's documents. Firstly, the shareholders should be provided access to the annual reports and other materials and information that pertain to the issues on the agenda of the meeting. In joint stock companies these materials should be held available at the company's head office prior to the general meeting of shareholders, while the materials should be sent to the shareholders alongside the invitation to the meeting in limited liability companies. The shareholders may specify other additional materials that the management should provide to the shareholders in connection with the general meeting of shareholders in the charter.

Secondly, the law grants the shareholders extensive access to the company's key documents, such as accounting documents, also outside the general meeting of shareholders. The shareholders are also allowed to specify other documents and materials that the management should provide the shareholders access to in the charter and by-laws. The Russian company laws thus grant the shareholders extensive access to documents and materials related to the company and its activities. Similar access is provided to shareholders of German limited liability companies and Swedish companies, while the shareholders of German joint stock companies and Finnish companies do not have similar access under the relevant laws. Hence, from an international perspective, the Russian law provides quite extensive access to company documents for the shareholders.

As a conclusion, the asymmetry of information between the management and a shareholder can become quite severe, if the shareholder is passive. However, an active shareholder can reduce the asymmetry of information by analyzing the information and materials that are necessary for evaluating and controlling the company's and its management's performance and consequently establishing necessary reporting duties for the management. The law also grants a shareholder extensive access to company documents and materials. An active shareholder can use this right to review the company's documents on its own initiate when

necessary to scrutinize the company's and the management's performance and conduct. Hence, the Russian company laws should not be considered to allow an exceptionally severe asymmetry of information between the management and a shareholder.

6.3. Supervisory and Control Institutions

The main supervisory body in the Russian company is the board of directors. The board, which is optional in limited liability companies and joint stock companies with less than 50 shareholders, should determine the company's primary directions, convene and arrange the general meeting of shareholders, approve and adopt by-laws in the extent assigned to its competence, decide on entering and exiting other commercial organizations, such as subsidiaries, approve major and related party transactions in the extent assigned to its competence and appoint and remove the executive management, if assigned to its competence. Notwithstanding that it is not explicitly stated in the company laws, one of the board's primary responsibilities is to supervise the executive management. The Russian Corporate Governance Code considers the company's annual business plan to be one of the main instruments that the board should utilize for exercising control over the management.

The Russian Corporate Governance Code recommends the board to establish an audit committee to oversee to company's activities and to ensure that effective internal control processes are in place. The audit committee should provide the board with information related to the company's activities, in particular, on issues related to the implementation of the business plan, violations and omissions committed by the management and other timely matters pertaining to the audit committee's responsibilities. The audit committee should also supervise the company's internal control service and maintain communications with the chief internal auditor, as well as recommend an auditor for the company to the board. The audit committee can be provided for in the charter, in which case the board is required to establish the audit committee. Alternatively, the board can be allowed to establish the audit committee on its own discretion. If the audit committee is provided for in the charter, the charter should specify its composition and main duties and responsibilities. Detailed rules on its activities should be set forth in a by-law, for example, in the Board of Directors Policy or the Audit Committee Policy. The audit committee can comprise of one or more members, depending on the size of the board and the company's organization.

The internal audit service, recommended by the Russian Corporate Governance Code, should perform continuous internal control over the company's finances and business operations and, in particular, review transactions and related documents to ensure that the transactions are in conformity with the business plan and the company's charter and by-laws. Any violations and omissions should be reported to the audit committee. The internal audit service should also assist the audit committee in collecting information on timely issues and participate in and provide information to the audit committee in audit committee meetings. The chief internal auditor should be guaranteed direct access to the chairman of the audit committee. The internal audit service could be provided for in the charter, which should in that case specify its composition and main duties and responsibilities. Detailed rules on its activities should be set forth in the Internal Audit Policy. The internal audit service constitutes, in practice, a department of the company headed by the chief internal auditor. In smaller companies the internal audit service can comprise of a single controller, possible appointed from the owner's organization.

To obtain an independent and objective statement on the accuracy of the company's annual reports and accounts, the shareholders may hire an auditor to review the company's reports and accounts. Hiring an auditor is optional in smaller companies in which the value of the company's assets or turnover does not exceed the threshold values specified in the law. The Russian company laws also provide for a peculiarity in the form of the revision commission, which in practice constitutes an internal auditor. The revision commission should review the company's financial and business operations. The general meeting of shareholders is not allowed to approve the annual reports before the revision commission has reviewed the reports. The revision commission, which composition should be set forth in the charter, is optional in limited liability companies with less than 15 shareholders but mandatory in joint stock companies.

The Russian company laws together with the Russian Corporate Governance Code and corporate practice thus provide for several corporate governance institutions vested with control functions. When setting up the company's corporate governance structure and internal control processes, the shareholders should plan the functions and responsibilities of the board and the other above-referenced institutions with care to avoid overlapping

responsibilities. The functions and main responsibilities, as well as the composition and reporting duties of the respective institutions (except for the external auditor) should be set forth in the charter, while detailed rules on their activities should be regulated by the by-laws.

6.4. Corporate Governance Instruments

The Russian company laws provide for two main instruments in which the company's corporate governance structure and internal control processes can be manifested. These constitute the company charter and the company by-laws, the charter constituting the company's founding document. The charter is registered with the state registration authority upon establishment of the company, after which any amendments to it should be submitted for registration with the same authority. The charter is the most relevant instrument for corporate governance purposes, since it manifests the company's corporate governance structure and provides for the distribution of authorities between the governing bodies. Only the general meeting of shareholders is competent to amend the charter.

The by-laws are internal documents that regulate the activities of the company and its governing bodies and other institutions and processes in more detail than the charter. They are adopted by the general meeting of shareholders or the board, depending on the activity that the by-law regulates and a possible internal distribution of the competence to adopt by-laws. By-laws are subordinate to the charter; in case of a conflict between the charter and a by-law, the relevant provisions of the charter should be applied. By-laws are binding for the company's entire organization and, in particular, for the institutions which' activity the relevant by-law regulates. Using by-laws to regulate the company's corporate governance and internal control activities brings flexibility to the organization of these issues, since by-laws are not subject to state registration. Instead, amending a by-law only requires a decision of the competent governing body. Key by-laws comprise the General Director Policy, the Board of Directors Policy and the Internal Audit Policy, or alternatively the Internal Control Policy.

The Russian Corporate Governance Code provides for a third type of instrument that can be utilized for corporate governance and internal control purposes, namely the business plan. The company's business plan should be presented annually by the management to the

board for approval. The business plan constitutes, according to the code, the company's primary financial document and should be used by the board to ensure that the company's priority directions are followed. The management should be required to follow the business plan. Any non-standard transactions, i.e. transactions outside the scope of the business plan, should require board approval. Implementation and compliance with the business plan should be monitored by the audit committee and the internal audit service. A similar business plan is not referred to in the corporate governance codes of the Western jurisdictions studied in this account. The shareholders of a Russian subsidiary may provide for the preparation of a business plan in the charter to allow the board to direct the company and control compliance with such directions.

The management's employment agreements also have place a in the corporate governance framework. The employment agreement should provide for the duties and responsibilities of respective manager. It should, however, be noted that detailed provisions concerning the general director's or a management board member's duties and responsibilities should preferably be included in the relevant by-law to allow the shareholders to adjust these responsibilities. Any restrictions to the management's authorities should be entered in the charter. The management's employment agreement can be terminated by a simple decision adopted by the shareholders or the board, depending on to which governing body this competence is assigned. However, if a legitimate reason for removing the general director or a management board member does not exist, the company is required to pay a severance payment to the relevant manager in the amount of no less than three average monthly salaries.

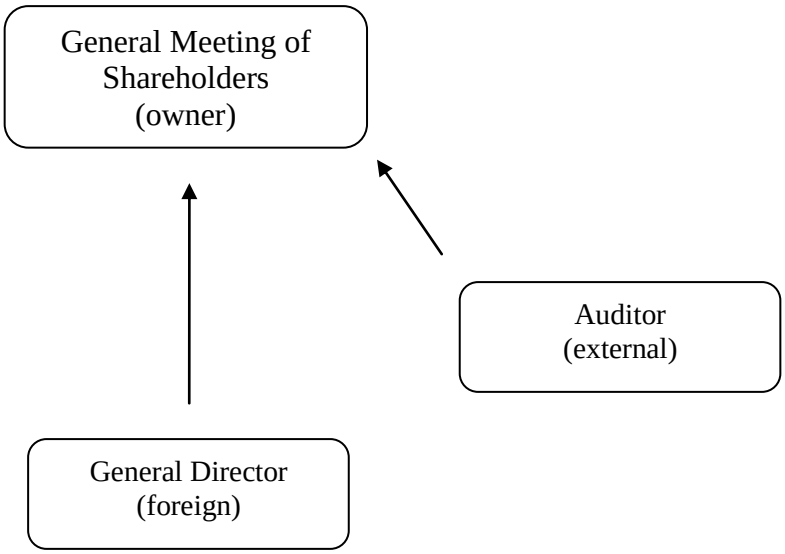
6.5. Control structures

In view of the above, a shareholder can establish different corporate governance and internal control frameworks in a Russian company. The following example structures illustrate a few options for arranging the corporate governance and internal control framework in a Russian subsidiary.[391]

[391] The management board is not considered in these examples owing to the reasons specified in Chapter 2.1.3 above.

In the first example structure the foreign owner-investor has appointed a foreign general director for the Russian subsidiary, possibly from its own organization. In this case extensive internal control processes should not be required, since the general director's ties to the owner are firmer than they would be with a general director hired outside of the organization or locally. It can therefore be expected that the loyalty of the general director is stronger than in ordinary shareholder-management relations, and that the general director would not act against the owner's interest in order to, for example, not lose a possible position in the owner's organization in the future. The owner should, however, establish reporting duties for the general director to allow the owner to evaluate the general director's and the subsidiary's performance. The general director could report directly to a representative of the owner. Since extensive supervision is not required, a board would not necessarily be needed. To ensure that the company's annual reports and accounts are accurate, the shareholder could hire an external auditor to prepare a statement of the reports.

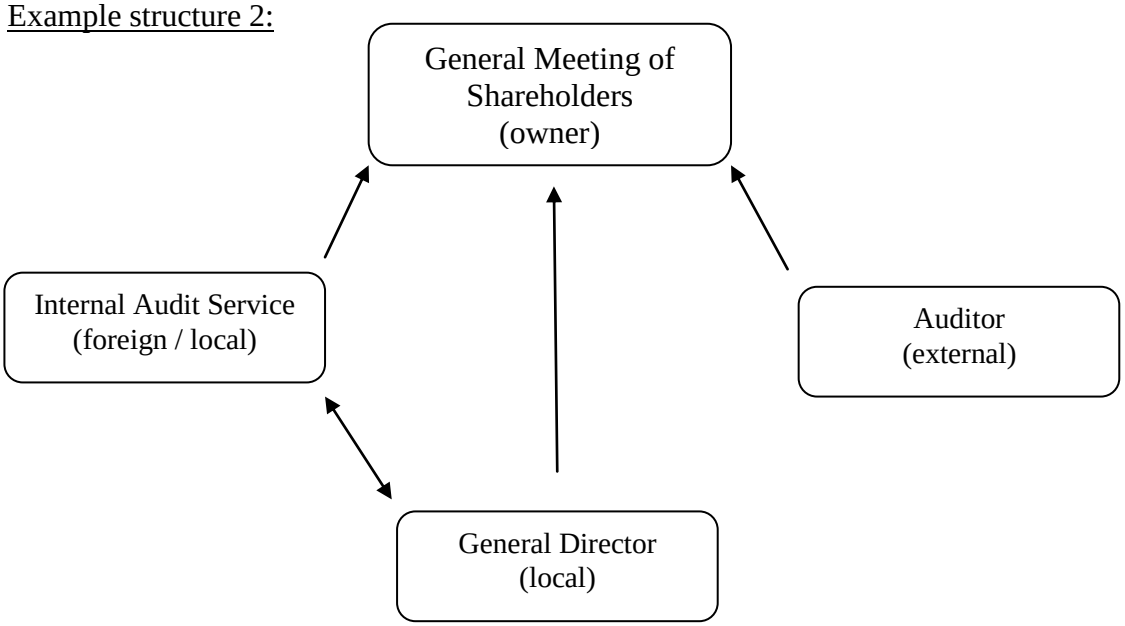
Example structure 1:



In the second example structure the foreign owner-investor has appointed a Russian general director for the Russian subsidiary. To ensure compliance with the owner's strategies and directions, as well as to safeguard against any abusive or unfaithful management behavior, the shareholder should estblish the internal audit service to ensure compliance with the given directions and strategies, as well as with the company's charter and by-laws. In smaller companies the internal audit service could comprise of an auditor or accountant, while in bigger companies the internal audit service could comprise the

chief internal auditor and subordinate employees responsible performing the internal auditing. The foreign owner may also appoint a controller from its own organization to oversee the company's operations, either as an employee of the internal audit service or as the chief internal auditor. The owner should establish continuous reporting duties for the general director, as well as for the internal audit service. The accuracy of the annual reports should be reviewed by an external auditor.

Example structure 2:



In the third example structure the owner has established a board of directors to supervise the Russian subsidiary's operations and its locally hired general director. The board may consist of one or more members (in joint stock companies at least five), and the members may be appointed from, for example, the owner's own organization or they can alternatively be local. It is essential that the board members are independent from the executive management and perform their duties and responsibilities with the objective to safeguard the owner's and the subsidiary's interest. The board should have an audit committee, or if such committee is not required owing to the size of the board and the company's organization, the responsibility to oversee the company's internal control systems should be assigned to a board member. The audit committee should maintain contacts with the internal control service and supervise its activity. The internal control service could consist of one or more members, presumably in this case the chief internal auditor and a few employees, amongst which a foreign controller could join. The chief internal auditor should report to the board's audit committee, which should review and

prepare timely matters for the board. The owner should also establish continuous reporting duties for the general director toward the board, which in turn should have continuous reporting duties toward the owner. The owner should hire an external auditor to review the accuracy of the company's annual reports and accounts.

Example structure 3: