CHAPTER 7

Evolution of Ownership Structure and Corporate Governance

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Highlights

- While theoretical conclusions about the advantages of different ownership forms are rather controversial, most empirical studies show that private companies outperform state-owned ones in numerous financial indicators.
- In Russia, the search for sources of economic growth and social stability led to a significant transformative development of ownership structures and corporate governance models. The reforms of the 1990s reduced state involvement in the economy; however, since the early 2000s, the public sector once again began to expand as measured by the share of GDP. The question of whether the economic growth model and scope of state involvement in the early 2020s are optimal has remained open.

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- Although a modern corporate governance model was implemented in Russia, its further development is hindered by a high degree of ownership concentration, a lack of transparency in business operations, and an orientation to own resources and debt as major sources of financing.
- During the years of reform, a liquid and open exchange market for shares and bonds emerged and effective stock market infrastructure was created. The key remaining issues are the development of the internal savings system, the implementation of new technologies, and the improvement of financial regulation.

7.1 Introduction: Private Versus Public Sector

The global trend towards a reduction in state ownership (state participation in commercial enterprises) has been characteristic of the late twentieth and early twenty-first centuries, although this trend can sometimes slow down or be temporarily reversed, especially during financial and economic crises.

The effect of privatisation on transformation and efficiency at the micro level is largely beneficial, although such changes can occur faster and easier where economic and government institutions are stronger and the quality of the legal and regulatory framework of economic activity is higher. On the other hand, partial privatisation can produce positive effects where institutions are weaker (Marcelin & Mathur, 2015). At the same time, when the government retains the controlling interest after partial privatisation, it can weaken the company's performance (Boubakri et al., 2005).

In practice, the privatisation process follows a cyclical pattern, reflecting the specific interests and preferences of the ruling elites and serving various goals—from systemic post-communist transformation to the achievement of certain ideological, structural, or budgetary (fiscal) objectives. It cannot be said that all the privatisation programmes implemented around the world since the 1980s have actually been successful. However, privatisation is not a goal in itself, but an economic policy instrument designed to introduce market rules for economic agents.

Russia, similar to other transition economies, has gone through the difficult process of institutional reform—from the choice of a primary privatisation model to modern standards of the public sector and corporate governance.[1] This chapter analyses the key trends in privatisation and corporate governance since the late 1980s.

[1] See, for example, Radygin (1995), Boyko et al. (1996), Blasi et al. (1997), Gaidar et al. (2003), Tambovtsev et al. (2009), Alexeev and Weber (2013), Grigoriev and Kurdin (2016), Radygin et al. (2019), Gurevich et al. (2020).

7.2 Privatisation from the Origins: Discussions, Models, and Results

In Russia, as in other post-communist countries, privatisation started in the late 1980s. The period 1985–1989 was characterised by minor changes in the Soviet system when any alternative forms of ownership were considered only in the context of a 'multi-structured socialist economy' with a dominant public sector (see Chapter 4). The years 1990–1991 saw more systematically implemented reforms or—to be more precise—the emergence of more systematic concepts of a pro-market transformation. There was a noticeable shift in the ideological approaches to ownership issues, which was reflected in the legislation adopted during that period (concerning ownership and joint stock companies, among others). Meanwhile, against the ongoing discussions about the alternative forms of ownership and the methods of privatisation, there was a surge in the spontaneous process of asset withdrawal from the public sector in the interests of the Soviet nomenclature and directors of state-owned enterprises (SOEs) (Radygin, 1992).

Although Russia, during privatisation, avoided facing problems like the restitution of property rights from the pre-communist period or a noticeable regional separatism, the scale of the Soviet economy, its high level of sectoral concentration, and the extremely politicised nature of the privatisation process predetermined the choice of a privatisation model that was focused on maximising social compromise. Table 7.1 presents the main stages of privatisation.

The most important systemic transformation period was the mass privatisation of 1992–1994 because it formed the primary ownership structure of Russian enterprises. The emergence of a significant stratum of private owners of various types was perceived as a necessary precondition for preventing a communist restoration. The process of the post-privatisation redistribution of property lasted for about a decade, and its main characteristic was the concentration of ownership in the hands of private majority shareholders.

Numerous studies (Aukutsionek et al., 2007; Dolgopiatova, 2002, 2007; Radygin, 2000; Radygin & Entov, 1999) present the main trends in the ownership structure of Russian companies: a reduction in employee ownership; stabilisation or growth in management ownership; a significant increase in the ownership share of large external investors; stabilisation or a reduction in the share of small external investors (individuals); and a consistent contraction in state ownership. Overall, ownership by internal shareholders declined (due to a decrease in ownership by ordinary employees), while that of external and pseudo-external shareholders increased. During this period, the key feature of the ownership structure of the biggest Russian joint stock companies was the ownership of stock by large state and private financial-industrial groups (holding companies) as well as low employee stock ownership with relatively high non-resident stock ownership.

Table 7.1 Main stages of privatisation in Russia

Period	*Stage characteristics*	*Priority goals*
1987–1991	Spontaneous privatisation process	Lack of specialised legislation, no formalised goals at the macro level
1992–1994	Mass privatisation (see Box 7.1)	Dominance of political goals and the search for social compromise, launch of reforms based on privatisation legislation, intensive build-up of 'critical mass' of relevant institutional changes
1995–1998	First monetary stage, including loan-for-share auctions in 1995	Combination of political and fiscal goals resulting in an unsuccessful transition to monetary model
1999–2009	Second monetary stage	Combination of fiscal goals and the consolidation of state-owned assets, the quantitative growth of the public sector
2010–present	Emphasis on public sector management, declarations of new large-scale privatisations in non-resource sectors	Combination of fiscal (mainly renewable sources—dividends, rent, among others) and optimisation tasks, continued policy of public sector consolidation

Source Authors' analysis

The impact of privatisation and the post-privatisation ownership changes on the performance of enterprises remains debatable, but empirical analyses revealed some positive trends. According to Megginson (2017), most studies show significant improvements in the financial and operational performance indicators of the former SOEs after privatisation. In addition, privatisation boosts the potential and efficiency of national capital markets. Claessens and Djankov (2002), using the example of Eastern European enterprises, demonstrated the positive effect of privatisation on revenues and labour productivity coupled with job losses. The economic and statistical significance of the post-privatisation positive effect increased over time. Estrin et al. (2009) assessed the impact of privatisation on the performance of companies in transition economies and in most cases found a positive effect. In countries of the former Soviet Union (FSU), such positive effects were observed only when control had been transferred to foreign investors. The degree of concentration of ownership can affect the efficiency of companies.

Most of the studies that covered Russia also found similar conclusions. The best performance was demonstrated by those enterprises where ownership was concentrated either in the hands of managers (in small- and medium-sized enterprises) or certain types of outsiders (in large enterprises), although there is also some opposing evidence (Aukutsionek et al., 1998). Radygin and Entov (2001) note that a shrinking share of state ownership translated into an increased return on fixed assets. At the same time, alongside an increasing concentration of joint stock ownership, indicators like revenue per employee, return on fixed assets, and profit margin generally improved. Brown et al. (2006) showed that privatisation in most cases led to labour productivity growth, but in Russia, it produced an opposite effect. The obvious positive effect of privatisation by domestic investors could be seen in the short term in Hungary, Romania, and Ukraine, and in later years, it continued to grow; however, in Russia, the positive effects were only revealed five years after privatisation. The results of privatisation vary dramatically across different countries depending on the degree of involvement of foreign investors.

Abramov et al. (2017) show that the size of the state-owned stake negatively influences a company's performance, and its increase is associated with a rising debt burden. Radygin et al. (2019), by comparing the economic and financial performance indicators of the largest SOEs, prove that they usually underperform private Russian companies and their foreign competitors.

In the early 2000s, the pace of privatisation in Russia slowed down. Monetary privatisation in the second half of the 1990s, which had been aiming at generating higher budget revenues and enterprise restructuring, did not bring satisfactory results. The bulk of property remaining in state ownership was represented either by low-liquid assets or, on the contrary, by very attractive ones (for example, state-owned stakes in monopolies of national importance), the sale of which at an adequate market price could be possible only upon meeting certain prerequisites. After the financial crisis of 1997–1998 (see Chapter 16) followed by the stock market collapse, the prospects for any serious growth in budget proceeds through privatisation sales dimmed even more.

In 2000–2005, government policy was aimed, for the most part, at optimising the state's participation in the economy. In subsequent years, it became more prominent due to the expansion of SOEs and their participation in mergers and acquisitions (M&As).

After 2005, the processes of consolidating scattered state-owned assets and pooling them into vertically integrated structures under state control (pseudo-privatisation), increasing the state's stakes in the biggest public companies, among others, sharply intensified. In some instances, these integrated structures covered entire industries (e.g., aviation, nuclear industry, and shipbuilding).

Furthermore, the years 2007–2008 saw the creation of state corporations and development institutions. Similar to other countries, the global financial crisis (GFC) of 2008–2009 led to an increase in indirect state ownership. However, Russia, unlike other countries, did not re-privatise these assets in 2010–2012. The expansion of indirect state ownership went on throughout the period 2014–2021, affecting a variety of sectors (i.e., oil, banking and finance, and trade, among others).

In summary, one may say that the privatisation trends in the 2000s and 2010s appear ambiguous. The number of economic entities with state participation (the indicator applied in official Russian statistics, government documents, and statements to illustrate the role of state versus private ownership) declined, which suggests a consistent denationalisation trend (Fig. 7.1). At the same time, the role of the state has been gaining in strength by inertia, according to the growing share of the public sector in GDP and other macro indicators (see Sect. 7.3).

In the political and economic sense, the situation can be described in terms of a 'reluctant' or 'delayed' privatisation (Bortolotti & Faccio, 2004). Evidently, the choice was made in favour of the model of state capitalism, which essentially implies government control over key national assets, promotion of the development of 'national champions' in globally competitive industries, and investment through state-controlled institutions (Megginson, 2017, p. 1).

Box 7.1 Mass Privatisation Schemes
The total number of enterprises at the beginning of mass privatisation (1992) was about 240,000, which thus meant that standardised procedures were required. A significant component of the model was the privatisation voucher, which was designed to build up political support and effective demand. The State Programme of Privatisation of State and Municipal Enterprises in the

Fig. 7.1 Nominal trend: a decrease in the number of economic entities with state participation, 1999–2020 (*Note* SOEs—state-owned enterprises; FSUEs—federal state unitary enterprises; FSIs—federal state institutions. *Source* Federal Agency for State Property Management)

Russian Federation for 1992, which became fundamental for the mass privatisation of 1992–1994, was approved by the Supreme Council of the Russian Federation on 11 June 1992. For the purposes of privatisation, all enterprises in Russia were divided into three groups: small enterprises (with fewer than 200 employees and with a book value of fixed assets below RUB 1 million), which were privatised through auctions and tenders; large enterprises (with more than 1000 employees and with a book value of fixed assets above RUB 50 million), which were reorganised into open joint stock companies (corporatised) with a mandatory stock market offering; and all other (medium-sized) enterprises, which could use any method of privatisation, including voluntary corporatisation. If employees decided to privatise the company through a market offering of stocks in an open joint stock company (OJSC), one of the following three privatisation methods would be applied: option 1, which included the transfer of registered non-voting shares worth 25% of the authorised capital at par value to all employees, the sale to the employees of ordinary (voting) shares worth up to 10% of the authorised capital at a discount of 30% of the par value, and the sale to the managers of ordinary shares worth 5% of the authorised capital at par value; option 2, which granted all employees the right to buy ordinary shares worth up to 51% of the authorised capital at par value multiplied by a factor of 1.7; and option 3, which granted a group of employees the right to purchase at par value ordinary shares in their enterprise worth up to 20% of its authorised capital if they fulfilled certain conditions as well as the sale of ordinary shares worth up to 20% of the authorised capital to all employees at a 30% discount. Evidence shows that the second option was the most attractive for employees of privatised enterprises—it was chosen by 70–80% of companies.

7.3 Public Sector: Quantitative Dynamics and Comparative Effectiveness

The size of the public sector and its share in the business ownership structure have a significant impact on the performance of companies and the economy as a whole. However, there are no unified methods for measuring the size of the public sector, and no single definition of SOEs. In this chapter, we define SOEs as organisations with the state acting as their sole owner or holding the direct or indirect majority stake or a substantial minority stake (shares in the authorised capital) of at least 10%.

To estimate the share of the public sector in GDP, we rely on our own methods using the calculated added value of three sectors of the Russian economy: SOEs,[2] state unitary enterprises (SUEs), and general government (GG).[3]

The share of the public sector in GDP, according to our estimates, jumped from 31.2% in 2000 to 51.1% in 2020, which was caused primarily by the increasing share of the largest SOEs in the fuel and energy, finance, and transport industries; the creation of large development institutions; the nationalisation of several major companies (TNK-BP, Bashneft, Magnit, Otkrytie Bank, Binbank, and Promsvyazbank); and an expanding share of the GG in GDP.

These estimates can be compared with data on the share of the public sector in GDP in 1992–2010 released by the European Bank for Reconstruction and Development (EBRD) in its annual Transition Reports. According to these data, in the 1990s, the share of the public sector in GDP shrank from 75% in 1992 to 30% in 1997 and then remained at that level until 2004. In 2005, it increased to 35%, remaining the same until 2010.

According to IMF (2019) estimates, the size of the public sector in the Russian economy was 32% of GDP in 2012 and 33% of GDP in 2016.[4]

According to the estimates of the Federal Antimonopoly Service (FAS) cited in its annual reports on competition in Russia, the share of the public sector in the Russian economy increased from 25% in 1998 to 70% in 2019. Incidentally, the FAS does not disclose its calculation methodology.

As noted earlier, the public sector in Russia expanded in quantitative and qualitative terms from the 2000s onwards. The quantitative expansion trend in the public sector prevailed in 2000–2008, and then in the 2010s, the situation changed when the inputs of SOEs in the key economic indicators stabilised or slightly increased, mainly due to cyclical changes in certain sectors characterised by different levels of state presence. Meanwhile, the strengthening position of the state in the economy acquired a qualitative character. This was

[2] Value added was estimated for a sample of the 144 largest SOEs. In the absence of data on the components of value added for a number of companies, their share in GDP was calculated based on their revenues and the ratio of value added in revenues for the rest of the SOEs.

[3] General government (GG) includes two types of organisations: public authorities and administrations at all levels—ministries, departments, services, agencies, and state extra-budgetary funds, among others, as well as non-market non-profit organisations funded and controlled by the state (schools, hospitals, and cultural organisations, among others). The share of GG in GDP is calculated based on the value added of the GG, reflected in the System of National Accounts (SNA). For indicators of the share of the public sector in GDP, see https://ipei.ranepa.ru/kgu.

[4] In the IMF (2019) methodology, the share of SOEs in the value added of industries was determined separately for each sector. Depending on the data availability, these shares were calculated using revenue or number of employees, and in the banking system—by the value of the banks' assets. Such a method may result in an underestimation of the final data because the share of the largest SOEs in value added is significantly higher than their shares in revenue and employment in the economy as a whole. In addition, the use of non-consolidated data for large Russian holding companies and their subsidiaries is a serious limitation of these calculations.

achieved primarily by increasing the role of state institutions in the distribution of financial resources and the control of economic agents, expanding the spheres (control zones) subject to state regulation, boosting the activity of state corporations and development institutions, transferring to their authorised capital the property of state-owned companies that were not publicly traded, and involving private companies in non-market mechanisms for coordinating certain management decisions. The ambivalence and inconsistency of the position of the state as a legislator, regulator, and direct owner of large companies give rise to a conflict of interests, which in practice manifests itself in the policy of double standards towards Russian businesses.

As shown in Fig. 7.2, the share of SOEs in GDP increased from 20.0% in 2000 to 34.4% in 2020. Over the same period, the share of SUEs dropped from 4.1% of GDP to 1.9% as a result of government policy aimed at the gradual elimination of this generally inefficient organisational and legal form. The share of the GG increased from 7.1% to 14.6% (close to the average of 27 European Union [EU] Member States, which stood at 14.0%).

In the 2000s and 2010s, the increasing presence of the state in the economy was observed alongside a significantly strengthening role of SOEs as issuers of securities in the stock and corporate bond markets. The share of SOEs in the capitalisation of the Russian stock market increased from 47.4% in 2000 to 49.9% in 2020. Their share in the value of outstanding corporate bonds increased from 11.2% in 2003 to 71.0% in 2020. The share of SOEs in the dividends paid likewise increased significantly, from 9.7% in 2006 to 56.0% in 2020. This is an indication of the domestic market's stronger orientation

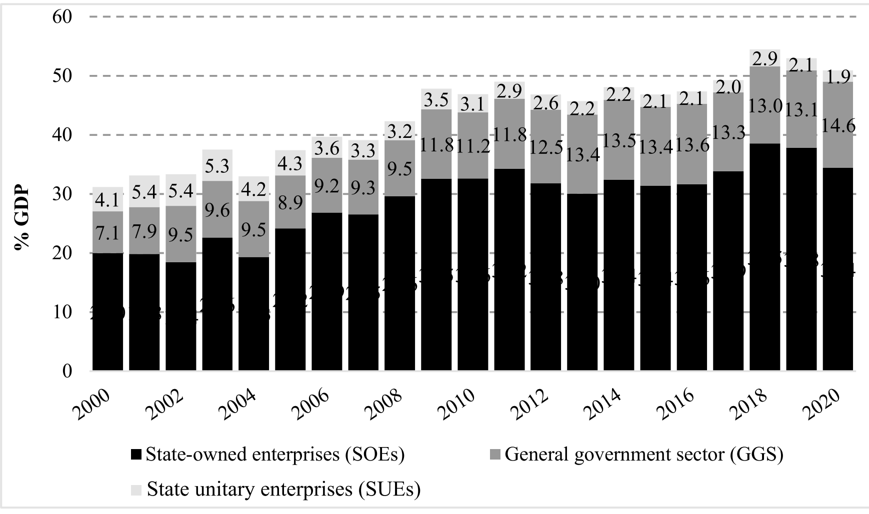

Fig. 7.2 Shares of SOEs, SUEs, and GGS in GDP in 2000–2020, in % (*Source* Authors' calculations)

to issuers operating in the industries where SOEs dominate (i.e., fuel and energy, finance, transport), to the detriment of new private issuers, and to the expansion of the already existing privately owned companies.

The mandatory requirement that the largest SOEs should earmark at least 50% of their net profit for dividends helped increase budget revenue and boost the market value of shares in those companies.

A comparison of the samples of 144 SOEs and the 169 largest (by their proceeds level) private companies operating in Russia over the period 2006–2020 reveals the fact that private companies consistently outperformed SOEs in terms of return on equity (ROE) and the price-to-book value (P/BV) ratio (Fig. 7.3). At the same time, SOEs outperformed private companies in terms of operating margin (the ratio of operating profit to revenue), which, as a rule, indicates that these companies more frequently resorted to the policy of price increases to improve their financial performance indicators. Besides, from 2013, SOEs demonstrated a lower debt burden on assets. This means that private companies are forced to borrow more actively in order to finance their projects. In terms of the growth rate of their sales (proceeds), both groups performed similarly.

7.4 Corporate Governance: Panacea or Imitation?

Globalisation and competition, changes in the structure of shareholders, the emergence of new industries, the development of financial markets, and digital technologies are the driving forces of corporate governance reform in many countries around the world. Corporate governance issues have gone beyond national borders and become the subject of international regulations, for example, the OECD Principles of Corporate Governance (OECD, 2015).

In Russia, the regulations and practices of corporate governance have evolved over time. In the 1990s, despite the adoption of the basic norms of corporate law,[5] the standards of good corporate governance practices were not complied with, which can be explained by the primary post-privatisation redistribution of property in the corporate sector.

The second period (approximately 2000–2003) was characterised by obvious progress when corporate governance issues began to interest the largest companies (corporate groups). This happened alongside an ongoing concentration of equity capital, enterprise M&As, the reorganisation of established business groups (holding companies), intra- and inter-industry expansion, and a search for foreign financial sources. The first Corporate Governance Code was adopted in 2002.

It was intended to fill the existing gaps in the Russian legislation on joint stock companies. In the early 2000s, some large Russian companies disclosed

[5] Federal Law No. 208-FZ dated 26 December1995 'On Joint Stock Companies', with amendments to Federal Law No. 120-FZ dated 07 August 2001 'On Joint Stock Companies'.

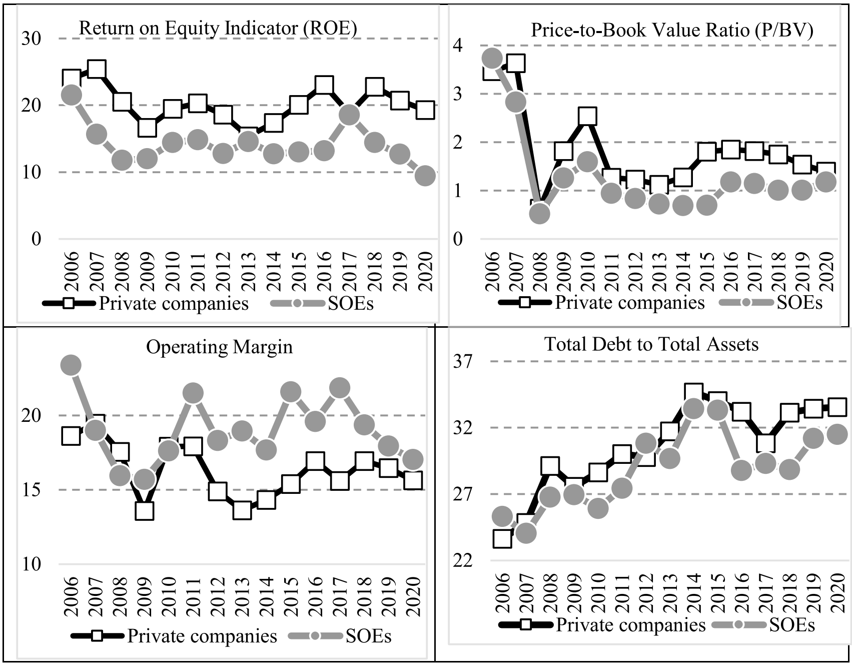

Fig. 7.3 Average financial ratios and performance indicators of private companies and SOEs in Russia over the period 2006–2020 (*Notes* ROE—net income available for common shareholders/average total common equity, in %; P/BV—price-to-book value ratio; operating margin—operating income/total sales, in %; total debt to total assets, in %. *Source* authors' calculations)

information on their beneficial owners, the remuneration of the members of their boards of directors, and the number of their independent directors, including foreign ones, among others. An increasing percentage of Russian companies began to pay dividends to their shareholders and disclosed the rules of transactions in their own shares conducted by their senior managers and members of boards of directors.

However, these positive practices were demonstrated only by the largest private companies. The assessment of the level of corporate governance in 140 Russian companies undertaken in 2004 by the Russian Institute of Directors and the Expert RA agency showed that only one company corresponded to the highest level ('A'). A 2003 study of 307 open joint stock companies revealed no broad commitment to the implementation of good practices. Furthermore, 50% of companies believed it to be important and one of their three priority goals, 17% of companies considered the development of corporate governance standards to be their priority goal, and, for about one-third of companies, it was insignificant (compared with their other goals). According to the corporate governance index calculated on the basis of 18 indicators, only 11% of companies were rated to have 'good practices'.[6]

The third period (2004–2008) was characterised by the deep freeze put on *high-quality* corporate initiatives and the increasing role of the state and SOEs in the corporate control market. The new trends translated primarily into increased opportunities for developing ownership structure transparency, beneficial owners, and financial openness, among others. There was growth in the number of initial public offerings (IPOs)—which peaked in 2006–2007—and cross-border M&As, which were often viewed as a tool for protecting businesses by attracting large foreign investors.

In the early 2000s, the arrival of external shareholders with a stake of 3–4% in some of the largest companies, usually of foreign origin, made it possible to speak of the emergence of a new type of outsider in Russia's corporate governance system. This was a partial transition from 'oligarchic' to 'public' corporate governance principles.

Meanwhile, the formation of a transparent corporate governance infrastructure in large companies was completed. It included corporate codes, internal regulations, quotas for independent directors, committees for working with shareholders, and corporate secretaries, among others. Nevertheless, the demand for innovation came primarily from the 'second-tier' companies which were preparing to enter the financial market.

Among the leaders were newly founded companies and a narrow group of companies that publicly raised funds on the international financial market and were listed in the United States (Shvyrkov, 2008). On the other hand, the least transparent aspects of corporate activities were ownership structure, the remuneration of top management and boards of directors, related party transactions, and relations with minority shareholders (see, e.g., Alexeev & Weber, 2013; Guriev et al., 2004; Chapter 9). Seemingly, there also exists a certain relationship between a company's achieved equity concentration level and ownership structure transparency.

The GFC of 2008–2009 provided a new impetus for corporate governance reform on a global scale and in Russia. First of all, there were some noticeable alterations in corporate legislation. In 2009, the Concept of the Development of Civil Legislation was approved, and on 1 September 2014, a new version of 'The Legal Entities' chapter of the Civil Code of the Russian Federation came into force.[7] In June 2015, significant changes were also made to the Federal Law 'On Joint Stock Companies'. The scale of amendments to the

[6] The project 'National rating of corporate governance' of the consortium 'RID-Expert RA' (www.rid.ru, www.raexpert.ru); Corporate governance practice in the regions of Russia. IRG research and commissioned by the International Finance Corporation (IFC), 2003.

[7] Federal Law No. 99-FZ dated 5 May 2014 'On Amendments to Chapter 4 of Part 1 of the Civil Code of the Russian Federation and on Invalidation of Certain Provisions of Legislative Acts of the Russian Federation'.

Civil Code was comparable with 1995 when Part I of the Civil Code replaced Soviet legislation (see Chapter 5).

The next few years (2015–2021) can be described as a period of adjusting the regulatory infrastructure of the largest public and private companies to international standards and the formal requirements issued by the national mega-regulator (i.e., the Bank of Russia[8]).

Russia's new Corporate Governance Code[9] adopted in 2014, this time at the initiative of the Bank of Russia, was more consistent with the OECD Framework Principles of Corporate Governance.[10] In this connection, the companies listed on the Russian stock exchange demonstrate the highest degree of compliance with best corporate governance practices, formally meeting nearly all requirements stipulated in the Code.

The Russian Corporate Governance Code is a form of soft law, and together with hard law (legislation), it makes up a system of hybrid regulation. In such a model, laws regulate the organisation of the board of directors, the rights of shareholders, the presence of an audit committee, and mandatory external audit. The Code addresses the issues of the independence of board members, internal control and risk management, and the remuneration and appointment of committees. Compliance with the Russian Corporate Governance Code is voluntary, but the companies whose securities are traded at organised auctions are required to follow its principles on a 'comply-or-explain' basis.

The comply-or-explain approach is believed to be more effective, as it allows companies to adapt the corporate governance rules more flexibly to their own specific features and gives them relative freedom in adopting the most appropriate management structures to improve their performance. Nevertheless, it is more costly to implement, especially in less developed economies.

The formal expert assessment of the new regulations rated them very high. As early as 2016–2017, the EBRD (2017) ranked Russia as a country with a moderately strong code (on a scale of 1 to 5): '4'—most of the code meets its purpose, but further reforms are needed in some of its aspects.[11] It is significant that the countries practicing the comply-or-explain approach received the highest scores (besides Russia, these were Estonia ['4–5']; Poland, Slovenia,

[8] The alternative name of the Central Bank of the Russian Federation.

[9] See: Letter of the Bank of Russia dated 10 April 2014 No. 06–52/2463 'On the Corporate Governance Code' // Bulletin of the Bank of Russia, No. 40, 18 April 2014; Information Letter of the Bank of Russia dated 26 April 2019 No. IN-06–28/41 'On recommendations for organising and conducting self-assessment of the Effectiveness of the Board of Directors (Supervisory Board) in public Joint Stock Companies' // Bulletin of the Bank of Russia, No. 29, 30 April 2019.

[10] The new OECD/G20 Corporate Governance Principles adopted in 2015 retained the main features and content of the 2004 principles but included more detailed recommendations. By no means being revolutionary, they nevertheless sought to raise standards in a number of areas, better reflect differences in the global corporate governance system, and recognise the limits of global convergence of corporate governance practices.

[11] See http://www.ebrd.com/what-we-do/sectors/legal-reform/corporate-governance/sector-assessment.html.

and Croatia ['4']; and Latvia and Lithuania ['3–4']). However, despite the upgrade of Russia from a good ('3') to a moderately strong ('4') ranking in December 2017 (OECD, 2017), it was noted that only 5 of the top 10 listed companies disclosed information on their compliance with the code. Incidentally, most of the explanations provided were too formal and lacked important references to the companies' current corporate governance practices. In addition, the EBRD pointed out the absence of references to the Code as a source of rights and obligations of companies in judicial practice.

Since 2015, the Bank of Russia has been reviewing reports on compliance with the 2014 Corporate Governance Code submitted by public joint stock companies included in the Levels 1 and 2 quotation lists of the Moscow Exchange. The results of this analysis (Table 7.2) show an increase in the number of principles that these companies were complying with fully. In the 12 state-controlled joint stock companies, the average compliance index was 90%. The provisions set forth in 'Board of Directors' chapter were complied with the least. The largest SOEs explain their non-compliance, in particular, by the specificity of their capital structure.

However, in their monitoring, both the Bank of Russia and other institutions primarily applied the open information released by the companies (quarterly and annual reports, reports on compliance with the principles of the Code, lists of affiliated persons, and reports on material facts, among others) and did not verify its reliability.

The institutions that conducted the analyses noted the highly formal nature and incompleteness of information in the reports provided by companies, especially their explanations for non-compliance with the corporate governance rules. According to the Deloitte CIS Corporate Governance Centre, the level of compliance of Russian companies with the best corporate governance practices is not increasing because of the waning interest of foreign investors in their assets as a result of Western sanctions (see Chapter 14). Among the existing constraints, the highly concentrated ownership structure in Russian companies is also noted, with an average controlling stake amounting to 57.6%, whereas usually it is minority shareholders who desire to appoint independent directors. Meanwhile, in 2014–2015, the practice of placing high-ranking civil servants on the boards of directors of SOEs was resumed, and the comply-or-explain principle was not yet fully realised (Petrova et al., 2016).

The National Corporate Governance Index 2020[12] showed, after 2017–2018, a more limited disclosure of information on compliance with the Code by the top 100 companies by market capitalisation monitored by the Bank of Russia. In 2020, the positive trends included the presence of independent directors in almost all companies (against 20% in 2015); the inclusion in

[12] National Corporate Governance Index 2020. TopCompetence. https://corpshark.ru/p/natsionalnyj-indeks-korporativnogo-upravleniya-2020-rucgi/.

their board meeting agendas issues like sustainable development, social responsibility, and digital business transformation; and regard for environmental, social, and governance factors when making investment decisions. Nevertheless, only 25% of companies made significant efforts to improve their corporate governance quality and increase transparency.

A joint study by Ernst and Young and the Skolkovo Club of Independent Directors (2020) gave a generally positive assessment of the response of boards of directors to the COVID-19 pandemic, but also noted several drawbacks: insufficient attention to risk management, crisis scenarios, and strategy; unsatisfactory quality of information provided to boards of directors; and lack of trust between the board and management.

Russia has adopted the one-tier (Anglo-Saxon) structure of the board of directors (sometimes called a supervisory board). Therefore, the board of directors (supervisory board) is the central element in the corporate governance system of a public joint stock company in Russia. However, contrary to world practices, the board of directors (supervisory board) in Russia is quite often the body that simultaneously performs the functions of strategic management, control, and supervision, and, in some cases, the current management of the corporation. The inclusion of a certain number of independent directors into a board of directors operating in such a format cannot eliminate the conflict (of interests).

The law 'On Joint Stock Companies' of 1995, with all the amendments introduced there up to 2002, attempted to copy the Anglo-Saxon model of protecting the rights of minority shareholders. However, the concept of corporate legislation development until 2008 (Ministry of Economic Development of the Russian Federation), which was updated in 2018, in a sense became a manifesto of the pro-majority model designed to protect the rights of the largest shareholders. Indeed, this was more in line with the real processes in the field of corporate control that were typical of a vast majority of Russian companies (Continental European model). At the same time, a radical change in the regulatory strategy should not give rise to new imbalances that would be detrimental to one or another group of subjects of corporate relations.

The development of a national model of corporate governance is influenced by numerous factors—for example, the situation in Russia's stock market and corporate control market; competition in commodity, financial, and labour markets; a balanced bankruptcy procedure; the general institutional environment; property rights protection; contract enforcement mechanisms; and incentives for external and internal investments, among others.

Internal corporate initiatives and corporate culture are no less important. While corporate culture is the product of a long historical development, specific initiatives at the company level can be adopted only after appropriate objective conditions have been created. At the same time, real improvements across all aspects of corporate governance practices can also be considered generally to be an indicator of the institutional environment quality.

Table 7.2 Compliance with corporate governance practices in Russian public companies in 2015–2019, monitoring by the Bank of Russia

Chapter of Corporate Governance Code 2014	*Number of Principles*	*All public joint stock companies, %**				
		2015	*2016*	*2017*	*2018*	*2019*
Shareholder Rights	13	5	6	7	21	23
Board of Directors	36	0	0	0	0	2
Corporate Secretary	2	45	77	85	86	87
Remuneration System	10	6	5	11	13	15
System of Internal Control and Management of Risks	6	42	55	60	65	69
Information Disclosure	7	15	17	25	33	48
Significant Corporate Actions	5	7	9	7	10	11

Notes Number of joint stock companies: 2015—99, 2016—84, 2017—75, 2018—65, 2019—64. Since 2018, monitoring also includes companies whose shares are included in the Level 3 quotation list (155 in 2018 and 154 in 2019)
Source https://www.cbr.ru/issuers_corporate/analitics; https://www.cbr.ru/Collection/Collection/File/31741/Review_corp_14122020.pdf

7.5 Stock Market: Historical and Future Challenges

The first legal acts regulating the Russian stock market were adopted in 1990–1991. The creation of a liquid stock market was primarily the result of mass privatisation, which was launched in 1992 with the corporatisation of large SOEs and the issuance of privatisation vouchers.

As shown in Fig. 7.4, the development of the Russian stock market during 1993–2020 was uneven. Over 28 years, it experienced four major financial crises: in 1997–1998, 2008–2009, 2014, and 2020. As a result of the rapid stock market growth in the late 1990s-early 2000s, the capitalisation and liquidity indices peaked in 2007. Then, in 2014, the capitalisation and exchange trading volume plunged to 24.9% and 7.8% of GDP, respectively, and after 2015, they once again rose to 48.1% and 18.6% in 2020. Nevertheless, the capitalisation and trading volume of the Russian stock market in 2020 stood approximately at the level of 2003. The share of capitalisation of Russian companies in the global capitalisation index hit its record high of 2.5% in 2007 and 2010, and the share of stock trading volumes amounted to 1.4% in 2007. In 2020, the global share of the Russian stock market by capitalisation and stock trading volume was only 0.8% and 0.3%, respectively.

Given the insufficient level of development of domestic institutional investors, the capitalisation and liquidity of the Russian stock market largely depend on commodity prices in global markets and the behaviour of foreign

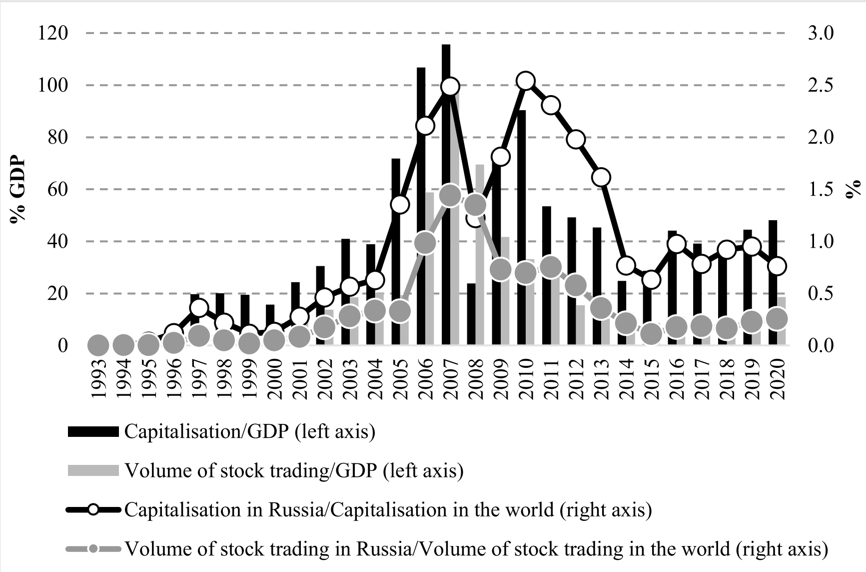

Fig. 7.4 Indicators of the capitalisation value and volume of stock trading in shares of Russian companies in GDP (%) and similar indicators in the world (%) (*Source* authors' calculations based on the World Bank's World Development Indicators, data of the World Federation of Exchanges https://statistics.world-exchanges.org/Account/Login, the IMF International Financial Statistics (IFS) database, and data of the Russian stock exchanges https://www.moex.com/)

portfolio investors.[13] It was only in the late 2010s that domestic retail investors began to play a more active role in stock market transactions. Their share in these transactions, according to the Moscow Exchange, increased from 35% in 2017 to 44% in 2020.

To understand the peculiarities of stock market evolution since the early 1990s, four equal time periods—seven years each—can be distinguished (Table 7.3). During the first period (1993–1999), the domestic stock market and its infrastructure were created in the course of mass privatisation. The second (2000–2006) was a period of steady stock market growth sustained by climbing raw material commodity prices, foreign investment inflow, and structural reforms in the economy. This was followed in 2007–2013 by the GFC of 2008–2009 and the subsequent recovery, with the increased volatility of oil prices and stock indices. And finally, 2014–2020 was a period of volatile commodity prices, weak investment activity, rising geopolitical risks, and the strengthening role of the government in the economy.

[13] According to the estimates of the Bank of Russia in 2019, the share of non-residents in the Free Float of shares of Russian companies was 52% (Bank of Russia, 2020).

Table 7.3 Average annual indicators of the Russian stock market at various stages of its development on the time horizon, 1993–2020

Indicator	*Years*			
	1993–1999	*2000–2006*	*2007–2013*	*2014–2020*
Growth rate of real GDP, %	−3.8	7.0	2.9	0.4
Growth rate of investments in fixed assets in USD, %	−19.3	33.8	20.0	−4.0
Price of Brent crude oil, USD per barrel	17.6	37.9	91.7	61.0
Inflation, %	191.4	13.9	8.8	6.3
USD to RUB exchange rate	9.7	29.3	30.9	64.7
Capitalisation, share in GDP, %	9.6	47.0	64.0	39.1
Stock exchange transactions, share in GDP, %	1.9	21.2	42.2	10.7
Number of listed companies per 1 million population	0.3	1.1	2.2	1.6
RTS Total Return Index, in USD, % per annum	88.0*	45.9	11.6	4.3
Corporate bonds, share in GDP, %	0.4**	1.5	5.7	11.5
Share of SOEs in capitalisation, %	N/A	40.9	49.4	49.4
Share of SOEs in outstanding corporate bonds, %	N/A	17.7***	33.5	61.1
Pension reserves and savings, share in GDP, %	0.2****	1.1	3.6	5.7
Net assets of mutual funds, share in GDP, %	0.04****	0.2	0.2	0.3

Notes * for the period 1996–1999; ** for the period 1998–1999; *** for the period 2003–2006; **** for the period 1997–1999

Source: authors' calculations based on the data of the World Bank's World Development Indicators, World Federation of Exchanges, the IMF International Financial Statistics (IFS), Bloomberg https://www.bloomberg.com/professional/solution/bloomberg-terminal/, Cbonds https://cbonds.ru/ and SPARK https://spark-interfax.ru/about, and companies' annual reports for different years.

In 1993–1999, the stock market was born in the unfavourable conditions of negative economic growth, a decline in investment in fixed assets in US dollar (USD) terms, and average annual inflation exceeding 190% per annum. In this situation, the goal of creating an organised stock market was part of market reforms aimed at building private ownership, boosting competition, and attracting foreign investment into the Russian economy.

In accordance with the Executive Order of the President of the Russian Federation No. 721 dated 1 July 1992, the State Property Committee and its regional agencies, over the period from July 1992 through June 1994, reorganised more than 22,000 state enterprises into joint stock companies

(Boyko et al., 1996), of which between December 1992 and June 1994, 15,100 companies were privatised with an average stake of 20% of the authorised capital (Blasi et al., 1997). Voucher privatisation involved millions of individuals in the stock market. More than 98% of Russian citizens received privatisation vouchers. In the course of voucher privatisation, 25% of privatisation vouchers were invested in voucher investment funds, 25% were sold to intermediaries, and the remaining 50% were invested in shares purchased either by employees in their own companies through closed auctions or at open voucher auctions (Chubais et al., 1999).

Privatisation gave rise to new financial intermediaries involved in transactions with vouchers. Some of them evolved into large investment companies operating according to Western standards. The stock market was organised on liberal principles, and from the very beginning, it became attractive to major foreign investment banks and funds. The risks of the Russian stock market during that period were very high, but the high rate of return for the most part offset those risks. Our calculations show the average annual return of the Russian Trading System (RTS) Index in 1996–1999 to be 88% per annum.

In November–December 1995, during the next wave of privatisation, the 'loans-for-shares' auctions were held, during which the shares in 12 major joint stock companies (Norilsk Nickel, Lukoil, YUKOS, Sibneft, Surgutneftegaz, Mechel, NLMK, and others) to the total value of USD 780 million were taken over by private entities controlled by financial oligarchs or former top managers of the privatised companies. To this day, these transactions raise criticism in society, because they are viewed as collusion between the executive power and oligarchs. Nevertheless, Treisman (2010) notes also some of their positive aspects, in particular, the fact that the consolidation of control over privatised companies by the oligarchs has significantly improved their performance measured against comparable SOEs.

In the second half of the 1990s, due to active privatisation, a liquid stock market emerged, and this was what the other FSU countries failed to achieve at that time. The most important steps in this direction included the following:

- Creation of a reliable system for registering title to shares in privatised companies with independent registrars;
- Introduction of the institution of a nominee holder of shares (1993);
- Creation of PAUFOR (hereinafter—NAUFOR), a self-regulating organisation of brokers (1994);
- Development of a regulatory framework for mutual funds as an alternative to the numerous financial pyramids of the 1990s (1995);
- Creation of an organised stock market based on the RTS (1995);
- Adoption of Federal Law No. 39-FZ dated 22 April 1996 'On the Securities Market'; and
- Creation of the Federal Securities and Stock Market Commission as a separate and independent executive authority.

As a result, by the end of the 1990s, Russia had developed a dynamically growing domestic stock market based on competition and private initiative, which, unlike the banking system, successfully survived the crisis of 1997–1998.

The period 2000–2006 was the most dynamic one for Russia in terms of economic and stock market growth. The average annual growth rates of GDP and investment reached 7.0% and 33.8%, respectively, and the average inflation rate plunged to 13.9%. The share of capitalisation in GDP increased to 47.0% and the volume of stock exchange transactions, to 21.2%, compared with the corresponding average indices of 9.6% and 1.9% over the previous seven years. The average annual return of the RTS Index was 45.9% per annum.

The growth of the economy and the stock market during that period was based on rising global commodity prices and an inflow of foreign portfolio investors. However, according to Kudrin and Gurvich (2014), economic development was also influenced by the ongoing market reforms. These included new budget, tax, labour, and land codes; an improving business climate; a programme of 'de-bureaucratisation' of the economy; and a reduction of the tax burden on the raw materials sector. In the early 2000s, foreign exchange legislation was liberalised, and Russia received investment-grade credit ratings from the rating agencies Moody's, Standard & Poor's, and Fitch, which contributed to an increased foreign portfolio investment inflow.

The stock market growth was facilitated by privatisation deals, the liberalisation of the market for shares in Gazprom, and the onset of the restructuring of RAO United Energy System (UES) Russia.

The biggest privatisation deals of the first half of the 2000s were the sales of a 49% stake in Rosgosstrakh in 2001, of 74.95% of shares in Slavneft to a consortium of Sibneft and TNK-BP in 2002, and of a stake in Lukoil (oil company) to ConocoPhillips in 2004. In 2006, an IPO of 15% of shares in Rosneft was completed, which were sold for USD 10.4 billion, and the following year saw IPOs by Sberbank and VTB Bank.

In 2005, the market for shares in Gazprom was liberalised: the 20% limit on ownership of its shares for non-residents was lifted, and so Gazprom shares could now be listed on Russia's major exchanges, the RTS and the MICEX.

In 2006–2008, in order to create a competitive electricity market and attract investments in the electric power industry, the state-owned holding company RAO UES Russia was reorganised by being divided into 23 independent private companies and only two state-owned ones—the Federal Grid Company (FGC) and IDGC Holding Company (Chubais, 2018; Urinson et al., 2020).

A serious test for the market was the conflict between the Russian government and Yukos Oil Company, whose CEOs in 2003–2004 were accused of tax evasion and other offenses. As a result of that conflict, the company's main asset, Yuganskneftegaz, was eventually taken over by Rosneft and Yukos itself was liquidated in 2007.

The GFC of 2008–2009 put an end to the long-standing trend of rising oil prices, their volatility increased, the growth of domestic investment slowed down, and foreign investment began to outflow. In 2007–2013, the average annual GDP growth rate plunged to 2.9% from 7.0% in 2000–2006, that is, by 2.4 times. Alongside an economic slowdown, the average rate of return of the RTS Index dropped from 45.9% to 11.6% per annum. The economic indicators point to the strengthening role of the state in the stock and bond markets. The economic policy choice was made in favour of increasing state participation in the economy and the allocation of financial resources. In 2007, state corporations and development institutions began to be rapidly set up (STLC, Rosatom, RVC, Rostec, Rusnano, and SME Corporation, among others). In 2014–2020, the average annual GDP growth rate plummeted from 2.9% in 2007–2013 to 0.4%, or by 7.2 times. From July 2014, sectorial sanctions were imposed against Russian businesses (see Chapter 14). However, an economic and investment slowdown had been triggered by internal factors even earlier, in the second half of 2012, when oil prices were relatively high and there were no sanctions (see Chapter 15).

In an effort to support the banking system's activity, from late 2012, the Bank of Russia began to increase its refinancing of banks (primarily state-owned ones) channelled through repo transactions, the volume of corresponding outstanding debt increasing as a result from RUB 3.0 trillion in December 2012 to RUB 9.5 trillion in December 2014. From 2014, the Bank of Russia took over the role of a mega-regulator of the financial market. This increased financial sector stability, while the financial market stagnated. Also from 2014, a moratorium was imposed on new contributions to the second pillar fully funded pension system (see Chapter 18).

This period was also marked by large transactions, during which shares of private entities passed into direct state ownership or to SOEs. In 2012, the state-owned company Rosneft bought 100% of shares in TNK-BP from its private shareholders. In 2016, by decision of the Arbitration Court of Moscow in response to the claim of the Prosecutor General's Office of the Russian Federation, 71% of shares in Bashneft, an oil company privatised in the early 2000s, were transferred into federal ownership, and later on, 50.075% of these shares were sold to Rosneft. In 2017, in the course of bankruptcy preventing measures, the Bank of Russia became the owner of shares in Otkrytie Bank, as well as in Binbank, the latter being merged with Otkrytie on 1 January 2019. Meanwhile, Promsvyazbank was also rehabilitated, and its shares transferred to the Federal Agency for State Property Management. In 2018, 29% of shares in the Magnit retail chain were transferred to VTB Bank.

Thus, the domestic stock market and the economy at large are currently faced with the task of finding new growth drivers. As shown in Table 7.4, Russia's share in the world by its key indicators of the depth of the stock market (share of capitalisation and stock trading in GDP, number of listed companies) is significantly below Russia's input in global GDP and share in world population. At the same time, the financial market development index calculated by the IMF was steadily on the decline.

The future prospects of the Russian stock market are for the most part associated with its reliance on domestic investors. The years 2020–2021 saw a massive inflow of private investors into the market. According to data released by the Moscow Exchange, the number of individual accounts with brokers increased from 3.9 million in 2019 to 16.8 million in 2021, or by 4.3 times. The number of investors in market mutual funds jumped from 0.5 million to 4.7 million over the same period, or by 9.4 times. The share of retail investors in stock trading increased from 35% in 2018 to 40% in 2021.

At the same time, the domestic stock market remains constrained by the underdeveloped domestic institutional investors, uncertainty about the prospects of mandatory pension savings and corporate pension plans, the low level of competition between financial structures, outdated standards for retail sales of financial products, the high collective investment costs for private investors, a limited inflow of new Russian companies listed on the domestic exchanges, and the volatility of foreign portfolio investment flows in the stock and bond markets (Radygin et al., 2021).

As the history of the Russian stock market demonstrates, its development could be facilitated by the privatisation of stakes in large SOEs. However, the question as to its future evolution remains open.

Table 7.4 Average annual share of Russia in the world by individual indicators of the stock market at various stages of its development, 1993–2020

Indicator	*Years*			
	1993–1999	*2000–2006*	*2007–2013*	*2014–2020*
GDP in USD at purchasing power parity, %	2.2	2.4	3.4	3.2
Investment in fixed assets, %	1.1	1.1	2.4	1.7
Population, %	2.6	2.3	2.1	1.9
Capitalisation, %	0.1	0.8	2.0	0.8
Stock trading volume, %	0.03	0.3	0.8	0.2
Number of listed companies, %	0.12	0.38	0.71	0.53
Average annual Financial Market Development Index for Russia, IMF coefficient	0.51	0.61	0.56	0.37

Source Own calculations based on the World Development Indicators (WDI) databases of the World Bank, the statistics portal of the World Federation of Exchanges, and the Financial Development Index Database of the International Monetary Fund https://data.imf.org/?sk=F8032E80-B36C-43B1-AC26-493C5B1CD33B

7.6 Conclusions

Despite the mass privatisation of the 1990s and the continuously declining number of registered SOEs, Russia in the 2010s had one of the largest public sectors in the world in terms of its share in GDP, capitalisation, and share in employment, among others. The public sector increased in the 2000s mainly in its SOE segment.

Unlike the situation in the early 1990s, political arguments in favour of privatisation have disappeared. Fiscal considerations are still important, but they are not as strong as in the 2000s. Accordingly, the main argument in favour of further denationalisation is the need for optimisation across the public sector as a whole and economic efficiency. This policy requires a pragmatic balance between retaining government influence in some sectors and its complete withdrawal from others, and replacement of state ownership with sectoral regulation and other forms of control over strategic companies.

Overall, the corporate governance model in Russia, both in its hard (the Civil Code and the Federal Law 'On Joint Stock Companies') and soft (the Corporate Governance Code) components, is no worse and no better than other national models, including in the OECD and EU countries. It covers all significant areas of corporate governance. The Russian Corporate Governance Code is a high-quality well-structured document, and its content is consistent with the international standards of corporate governance, including the OECD Principles of Corporate Governance. It is by no means inferior to, and sometimes surpasses, the codes of other countries.

The central question is what steps should be taken next to improve the quality of corporate governance? The easiest way would be to follow the path of formal improvement, in particular, a revision of legislation on joint stock companies and efforts to properly implement the Corporate Governance Code (e.g., the monitoring of private enterprises and SOEs and administrative pressure to improve their indicators, among others).

However, this is not enough. The main constraints are rooted in the period of the 1990s and 2000s: a relatively high level of joint stock ownership concentration, the 'closed' nature of most companies (while they formally remain public), the organisation of businesses in the form of groups of companies, the combination of management and ownership functions, the prevalence of own resources and debt as sources of financing, and over-compliant boards of directors, among others.

This majority-dominated model of joint stock ownership and corporate governance, in spite of the adequate quality of legislation, actually lacks a well-functioning classical system of checks and balances capable of protecting the interests of all parties. For obvious reasons, this is even more typical of SOEs, where the strategic and fiscal interests of the government can radically diverge from those of private minority shareholders.

The improvement of corporate governance quality in SOEs should not be reduced just to modifying its rules. It is necessary to stimulate the transformation of SOEs into public companies with IPOs and secondary public offerings of their stocks. Reducing the scale of direct state involvement in the economy also means increasing the scale of privatisation of large companies and synchronising federal and regional denationalisation policies.

The introduction of Western sanctions since 2014, which will probably be long term, inevitably brings to the forefront the issue of domestic competition, thus implying the increasing role of a market mechanism, including the continuation of privatisation programmes.

The large-scale privatisation carried out in the 1990s contributed to the formation of a liquid domestic stock market, which demonstrated rapid growth in the early 2000s, thanks to an inflow of forex earnings generated by exports and foreign portfolio investment. As these growth factors were exhausted, after the 2008–2009 GFC the investment mechanism was reoriented towards state development institutions and SOEs, and the role of financial regulation strengthened to maintain financial stability. The competition level in the stock market became lower. Alongside the increased volatility in global financial markets and rising geopolitical risks, all this brought down the pace of stock market recovery. The prospects for its further evolution will depend on the growth potential of domestic savings and the use of modern digital technologies. A new wave of privatisation could also give an additional impetus to its development.

Questions for Students

1. What were the main stages of privatisation in Russia, what were their major characteristics, and which of the stages was of the greatest importance for the systemic transformation of the Russian economy?
2. What was the dynamic of the public sector in Russia's GDP in 1992–2020 and its major characteristics?
3. Characterise the long-term changes in the ownership structure of Russian companies caused by privatisation. How have they affected their effectiveness?
4. What are the main features of the corporate governance model in Russian joint stock companies?
5. How has mass privatisation affected the Russian stock market and its features in comparison with other countries?

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