Chapter 5

Oversights in Russia's Corporate Governance: The Case of the Oil and Gas Industry*

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INTRODUCTION

Russia's corporate governance has been discussed widely in academic articles.[1] Nevertheless, very few of these papers effectively analyzed its "reality," which is interpreted here as real activities and real incidences. As Berglöf and Thadden (1999, p. 3) rightly indicate, corporate governance, defined as the mechanisms related to the decision-making process of firms, is likely to matter more in certain contexts or certain phases of economic development than in others. The process of determining when, why, and how much corporate governance matters necessitates asking empirical questions. Therefore, observation and an appreciation of the "reality" in each country is essential. In case of Russia, if we are not focusing on corporate groups in Russia, understanding the present "reality" in the Russian micro-economy is nearly impossible, because the concentration of sales, employment, and ownership by corporate groups has been developed. Therefore, in Russia, analysis of "corporate groups' governance" takes clear precedence over that of "corporate governance," and

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[1] See for example Afanas'ev, et al. (1997), *Corporate Governance in Russia* (2003), Dolgopiatova (2002, 2003), Iwasaki (2003), Judge and Naoumova (2004), Kostikov (2003), Kuznetsova and Kuznetsov (1999), Radygin (1999, 2002), Roberts (2004), and OECD (2002).

this is a key point for making geographical argument in relation to the oil and gas industry.

Another "reality," which most economists have left unnoticed, is that the security department of firms in Russia plays a big role in conducting economic activities. I have not yet found any critical discussion in which this point is openly addressed to make a case for corporate governance. It is well known that the head of the fourth section of domestic economic security in Yukos was arrested. This means that there are at least four sections related to economic security. Economic security sections are concerned not only with guarding firms, but also with collecting the data of rivals and dealing with security authorities. A number of large firms and banks have similar departments. Many former KGB staff and the police have been employed to work in these departments. Therefore, in Russia, the concept of economic security plays a great role in corporate activities. The importance of economic security has been increased as the role of information has grown. In other words, "competitive intelligence," defined as "a systematic and ethical program for gathering, analyzing and managing information that can affect a company's plans, decisions, and operations," in Russia should be the focus of future efforts (Nasheri, 2005, p. 73).

This chapter, first, will provide an overall view of corporate governance in Russia. Then, the first oversight, the "corporate groups' governance," will be analyzed. This argument leads us to conclude that Russian corporate groups' governance has been less developed, and, therefore, the legislation of applicable laws concerning holding companies, affiliated companies, and transfer pricing is very important. Lastly, some concluding remarks will discuss future issues in relation to corporate governance.

OVERALL VIEW OF CORPORATE GOVERNANCE

The importance of corporate governance depends on the level of economic development and the extent of capitalist economy. It is indicated that factors like investment opportunity and financial system are generally neglected, while the significance of financing from the stock market is overestimated, because corporate governance has been advocated primarily by developed countries (Berglöf and Thadden, 1999, pp. 5-6). Berglöf and Thadden define corporate governance as the set of mechanisms that

translate signals from product markets and input markets into firm behavior (ibid., p. 11). This definition focuses on two components: the signals generated outside the firm and the control structures inside the firm to execute decisions based on these signals. These signals are related to competition in markets and the control structure to execute decisions, which is related to corporate integration. The pressure from outsiders is only a part of mechanisms related to corporate governance. Employees, suppliers, competitors, and the Government are also involved in corporate governance. In transition economies, soft budget constraints, "strong insiders," and the "absence" of outsiders should be emphasized when analyzing corporate governance (ibid., pp. 19-21).

In this chapter, corporate governance can be defined as "mechanisms related to the decision-making processes of firms." This definition attempts to draw attention to how, why, and when firms are organized and operated. This view enables us to construct arguments about corporate governance comprehensively. However, in Russia, the meaning of corporate governance is rather narrow, which is apparently made clear when its Russian equivalent, *korporativnoe upravlenie*, is translated into English. *Upravlenie* is usually interpreted as "management" or "control." Hence, the problems of corporate governance in Russia are restricted within narrow spheres. I am afraid that this is the reason most economists regard corporate governance as factors related to only individual firms. However, corporate governance in Russia should be analyzed within corporate groups' governance, because these groups perform an essential role in the "real" Russian economy.

Corporate governance reflects phases of economic development, which necessitate government support and the institution of legislation. Hence, Russian corporate governance can be divided into three stages in the process of transformation from a socialist to a capitalist economy (Radygin, 2003, pp. 36-44).

During the first stage, prior to 1995, the concept of corporate governance was introduced in Russia. The Provisions on Joint Stock Companies (JSCs) were endorsed by the resolution of Republican Council of Ministers of Russia at the cabinet meeting on December 25, 1990. In the second stage, from 1995 and 2000, the first part of the Civic Code was enforced beginning on January 1, 1995, while the second part was established in 1995 and came into force from March 1996. In December 1995, the Law on JSCs was enacted. The Law on the Securities Market was also

established in April 1996. A comprehensive program on the rights of depositors and shareholders was approved, based on the Decree of the President of the Russian Federation, enacted on March 21, 1996. According to the Criminal Code established in June 1996, an abuse of power such as insufficient supply of information at the point of issuing securities was legislated to be as criminal.

In the third stage, after 2000, both the Law on JSCs and the Law on the Securities Market were revised.[2] Other laws related to corporate governance were also enacted and revised. As shown in Table 1, under the regime of the Russian President Vladimir Putin, a number of laws were introduced, enacted or amended in order to establish and maintain corporate governance.

Except for the laws shown in Table 1, Law on the Protection of Rights and Legal Interests of Investors in the Securities Market was established in March 5, 1999. In addition, the Federal Committee of the Securities Market (now the Federal Service of Financial Markets) adopted a number of resolutions.[3] Specifically, the Committee determined many resolutions concerned with information disclosure.[4]

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[2] Art. 42 of the Law on JSCs was revised on April 6, 2004, and enacted on July 1, 2004. Cl. 2, Art. 42, to the effect that the source of dividends is profits of the JSCs after payment of taxes, that is, net profits of firms, was added. The reason why net profits were exactly defined is that some firms tried to lower their net profits, which is the basis for dividends, regarding profits minus capital investments as net profits. For example, although an oil company, Surgutneftegaz, ought to pay dividends no less than 10 percent of net profits in its provisions, it was criticized for lowering the dividends of preference shares, because the definition of net profits was ambiguous. On July 7, 2004, another draft to revise the Law on JSCs was adopted in the first reading of the Lower House. In this draft, the following clause will be added: a holder of 90 percent of ordinary shares + 1 share of the JSCs or a holder of it with affiliated companies has the right to purchase the remaining shares, and the purchasing price should be the market prices approved by independent estimators (*Kommersant'*, September 24, 2004). But, in Russia there are many precedents whereby estimators estimate the value of shares unfairly.

[3] For instance, the standard on the occasion of establishing JSCs, and the standard of protocols of issuing additional shares and securities were endorsed by the Federal Committee of the Securities Market on September 17, 1996, and they were revised on November 11, 1998. The standard of protocols of issuing shares and securities on the occasion of reorganization of commercial organizations was approved on February 12, 1998, and was amended on November 11, 1998 (Medvedeva and Timofeev, 2003, p. 56).

[4] Although the Russian Law on JSCs prescribes the information presentation brought by JSCs (Art. 90), the information presentation to shareholders brought by JSCs (Art. 91), and obligatory disclosure of information brought by JSCs (Art. 92), the part of disclosure

Additionally, the Code of Corporate Conduct was endorsed by the Federal Government meeting under the guidance of the OECD. Then, it was approved by the Federal Committee of the Securities Market. The Code includes the principle of corporate conduct, the general meeting of shareholders, the board of directors, the executive organ of the firm, leaders of the firm, existing firm's behavior, disclosures concerning the firm, the control on financial and management activities of the firm, dividends, and the adjustment of confrontation among firms. The Code recommends the adoption of an appropriate form of management. For example, the recommendations endorsed the establishment of a strategic planning committee, a committee of auditors, a committee of staff and rewards, and a committee for the adjustment of confrontation among firms under the jurisdiction of a board of directors. The Code essentially is a trial for the introduction of an American-style of management.

Yet, has the Code of Corporate Conduct really been accepted by the Russian business community? According to data collected by the Russian Directors Institute and Managers Association during September and October 2002, only 15 percent of respondents were unaware of the Code of Corporate Conduct. However, only 19 percent responded that they had already established their own Code of Corporate Conduct (*Gotovnost' rossiiskikh kompanii*, 2002). Consequently, at least through autumn 2002, it was not reasonable to state that very many Russian firms actually practiced corporate governance, based on the Code of Corporate Conduct.

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was intensified by revision and supplement of the Law on the Securities Market. Art. 30 of the Law prescribes the obligation to disclose the report of settlement of accounts each quarterly on the occasion of issuing securities and registering them. In addition, the Federal Committee of the Securities Market has determined a number of resolutions concerning the disclosure. For instance, the Committee endorsed the resolution about procedures and the sphere of the disclosure on the occasion of issuing shares on April 20, 1998 (OECD, 2002, p. 74). On August 12, 1998, regulations concerning the disclosure of important incidents and behaviors, which have an effect on the financial and economic activities of issuers, were endorsed by the Committee. On April 4, 2002, the Committee adopted the resolution to recommend the utilization of the Code of Corporate Conduct, in which detailed information concerning whether the firm obeys the provisions of the Code of Corporate Conduct is required to be disclosed in the annual report (Belikov, 2003, p. 2). The provision of disclosure concerning affiliated companies of open JSCs was endorsed by the resolution of the Committee on April 1, 2003. On July 2, 2003, the provision of disclosure concerning securities issued by issuers was also approved by the Committee.

An empirical study is important to understand the three stages of the development of corporate governance. The structure of ownership is one of the crucial factors, which has an effect on corporate governance. As shown in Table 2, as time progresses, the structure of ownership also has changed. From Table 2, it can be concluded as follows: first, at the beginning of privatization, insiders like employees and managers held more shares relative to outsiders; second, as time progresses, the holding share of insiders had declined superficially, which mainly resulted from the decrease in shares held by employees; third, the holding share of managers appear inclined to increase at least since 2001; and, fourth, the holding share of individuals, that is, the public at large, as outsiders, has tended to increase, while the holding share of banks remains at a relatively low level.

Here, we should remember that it is difficult to distinguish between the insiders and outsiders, since companies and individuals who have significant relationships with managers are included in the outsider group. Even if the result of the investigation shows that the structure of ownership has been transferred from the insiders to the outsiders superficially, this is not the "reality." Additionally, in Russia, it should be noted that the major owners are honorary owners who do not in actuality control their companies. Hence, it is necessary to specify the differing groups and their differing responsibilities with terms such as the "beneficial owners" or "ultimate owners."

To appreciate the de facto "reality" which influences corporate governance in Russia, attention to the structure of ownership is important. The problems with focusing attention on ownership should be argued at the level of the firm, and also at the industrial or state level. While the focus on ownership at the company level has the possibility of making corporate governance more straightforward and relatively compliant, this could encourage investment, and lead to economic growth. However, if emphasis is placed at the state level, it may effectively become an obstacle by, for example, disrupting competition, and distorting economic policies to the advantage of some parts of monopolistic and oligopolistic firms (World Bank, 2004, p. 90).

Table 3 shows the result of questionnaires concerning concentration of ownership. Of the 213 firms surveyed, the average holding share of the largest shareholders increased from 26.2 percent in 1995 to 27.6 percent in 1998. The average holding share of the 1st–3rd largest shareholders

also increased from 40.4 percent to 44.5 percent. According to other data, these numbers seem to indicate that the rate of firms where one shareholder holds at least blocking shares also increased from 15 percent, when privatization began, to 33 percent in 2000 (Radygin, 2002, p. 108).

In this way, at the level of firms, the phenomenon of shares being concentrated in the hands of specific owners can be observed. It seems that a number of firms try to accrue as many shares as possible and thereby prevent interference from outsiders, since the legal rights of shareholders are relatively simple to subvert owing to court ineffectiveness. It is believed that the concentration of ownership stems from the limitations inherent in the enforcement of standards and laws enacted to protect the investor (La Porta, et al., 1998). On the other hand, concentration of ownership at the level of firms decreases the liquidity of shares, and makes it difficult for investors to monitor firms through the stock market.

Concentration of sales also has been increased. According to data collected from 1,700 firms during June and September 2003 by the World Bank, which covered 66 percent of sales and 22 percent of employment in industry, only 22 corporate groups had sales of more than 20 billion rubles or employ more than 20,000. These groups are shown in Table 4. Gazprom, Rosneft', UES, and Tatneft' are not included in it, because they are regarded as enterprises owned by the Federal or Regional Government. The sales of these 22 corporate groups accounted for 38.8 percent of the total. This sample amounts to 65.7 percent of total sales in industry, therefore, only 22 groups produce 25.5 percent of the total sales in industry. This indicates that concentration of sales has developed. On the other hand, concentration of employment is lower than the concentration of sales; however, 22 groups employ approximately 7 percent of the total employees in industry. Therefore, the role of corporate groups in the Russian economy is very important. This is the "reality."

CORPORATE GROUPS' GOVERNANCE

Some of Russia's excellent economists have already suggested that corporate groups are crucial factors and must be incorporated in any analysis of the Russian economy. Rozinskii (2002, p. 173) observes that a company as an economic entity has been disappearing. Kuznetsov, et al.

(2002, p. 71) indicate that official reports of the business accounts of firms do not reflect their actual conditions. Avdasheva (2004, p. 130) states that the characteristics of corporate groups concerned with corporate governance are as follows: (1) the relationship among shareholders in Russian corporate groups are opaque, and there are many cases in which a number of firms related to a parent company hold the controlling shares of subsidiary firms; (2) in addition, corporate groups try to change shareholders of their subsidiary firms in order to make the structure of ownership more opaque;[5] (3) in the holding companies, which are the fundamental type of Russian corporate groups, upstream firms hold shares of downstream firms to hide the controlling structure; (4) concentration of shares on shareholders or their affiliated companies has been developed; (5) the composition of the board of directors of firms belonging to corporate groups is characterized by their total control of them, not reflecting who and how many shares are held nominally; and, (6) in reality, the rate of ownership by insiders in share capital amounts is very high, that is, there are very few cases in which managers hold shares of their own firms openly. They are inclined to hold shares indirectly through their firms' network.

According to Avdasheva (2004, p. 123), corporate groups (business groups) include (1) firms producing products, (2) firm purchasing raw materials, (3) firms organizing the settlements between suppliers and consumers, and (4) banks financing firms' activities. She argues that factors to stimulate grouping or integration of firms consist of (1) imperfect protection against ownership, (2) exclusion of dual margins by the integration, and (3) reinforcement of the market control by horizontal integration (ibid., p. 126). However, in reality, transfer pricing and processing on commission played a greater role in the increase of vertical integration (ibid., pp. 127-129).

[5] After a parent company concentrates its shares on subsidiary firms and affiliated companies, and they come to be controlled by their parent company, the parent company begins to increase investment in subsidiary firms and affiliated companies in order to improve their performance. This is the same way in other countries (Shleifer and Treisman, 2003, p. 20).

TRANSFER PRICING

Transfer pricing enables a parent company to concentrate profits, to funnel profits to foreign subsidiaries, to transfer profits to subsidiaries located in well-established tax havens, or to simply evade taxes. The problems of transfer pricing are not limited to Russia. Expansion of foreign trade leads to the exploitation of transfer pricing to evade taxes. OECD has implemented a guideline for transfer pricing in 1979, and revised it into "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration" in 1995. Seen in this light, transfer pricing is a global concern. Specifically, in the case of Russia, not only in foreign trade, but also in transactions through domestic offshore companies and in the operations within corporate groups, transfer pricing is very widely employed, which ultimately results in a decrease in tax payments. It is said that against utilization of transfer pricing the tax authorities had made claims to banks, tobacco companies, Gazprom, Rosneft', TNK, and metallurgy holding companies in recent years (*Vedomosti*, p. A1, February 11, 2005).

Here, the case of transfer pricing in the oil and gas industry will be examined and discussed. First, utilizing transfer pricing, the question of how oil companies save their taxes will be explored. One of the well-known methods for minimizing the profit tax is the scheme of transfer pricing between domestic offshore companies and their parent companies or between affiliated companies registered in other preferential tax zones and their parent companies. This method could cut 16 percent points of 24 percent of the profit tax at the period of 2003. This scheme was realized as followed: (1) large-scale oil companies sold oil obtained from their subsidiary oil producing companies to their affiliated companies or dummy companies registered in domestic offshore or preferential tax zones by the price of one-half or one-third lower than the international price; (2) the affiliated companies sold the oil to their subsidiary refineries by the price of two thirds of the international prices, therefore, most profits were accumulated in the affiliated companies registered in domestic offshore or preferential tax zones.

The boom in establishing offshore companies by Russian residents and native firms occurred during 1992 and 1995. By the end of the 1990s, the number of offshore companies amounted to tens of thousands (ibid., p. 8). It can be confidently suggested that many major Russian firms are

connected with offshore companies in, for example, Cyprus, Gibraltar, the British Virgin Islands, Luxembourg, and the Netherlands. Nevertheless, it is important to note that Russian firms do not necessarily need to establish offshore offices, due to the existence of offshore zones, or Free Economic Zones within the borders of Russia proper (see Table 5). In addition to Table 5, so-called "domestic offshore" zones, which provide exemptions for a portion of the fees due for profit and property taxes, were introduced in the Mordovian Republic and Chkotka Autonomous Okrug (AO). To the firms registered in Baikonul preferential tax treatment was also supplied, based on the agreement between the Russian and Kazakhstan Governments.

As a result, in 2002, the ratio of profit tax in the profits before taxation of the profit tax in case of Lukoil, excluding foreign taxation, amounted to 31.8 percent. Yukos's ratio was 12.9 percent, TNK's ratio was 14.3 percent, and Tatneft''s ratio was 24.2 percent. Sibneft''s ratio was 12.3 percent, and Surgutneftegas's ratio was 24.9 percent. The rate of profit tax was 24 percent in 2002. The reason why the above ratio of Lukoil exceeded 24 percent was that Lukoil had to pay additional tax to the tax avoidance, utilizing Baikonul preferential tax treatment.

According to Ivchikov (2002), the mechanism of transfer pricing can be shown as follows: (1) the head oil complex buys oil from its subsidiary oil mining companies based on the transfer price; (2) within 30 to 40 percent of the oil, one portion is exported, and the remaining oil is processed on the condition of paying commission; (3) the processed products of oil are sold to domestic and foreign markets. It is important to know that in the oil sector, processing on commission became widespread, simultaneously utilizing transfer prices. Avdasheva and Dement'ev (2000, p. 21) indicate that such a well integrated oil company like Lukoil began to utilize processing of commission more aggressively than an oil company like Sidanko, where a core company played a smaller role on controlling. In addition, it has been proposed that the ratio of processing of commission in all products in oil refineries amounted to 90 percent in 1999 (*Neftegazovaia vertikal'*, p. 66, No. 12, 2000).[6]

In the oil sector, the commissioner supplies oil to the oil factory in order to process it, and then receives some parts of processed products for

[6] As for the data concerning processing on commission, see Avdasheva, 2001, p. 101.

resale, leaving the other parts in the oil factory as a commission fee. In this process, the price of oil supplied to the oil factory is set as a transfer price. Generally speaking, transfer pricing in the oil sector is utilized between mining companies and refineries. Both belong to the same group. This transaction is realized through mediators or the parent company. In the case of mediators, mining companies sell oil to mediators at a lower price than the market price, and the mediators sell the oil to refineries belonging to the same group. If mediators are located in the domestic or foreign offshore or preferential tax zones, they can avoid profit tax. Some parts of processed products are retained on the condition of commission, while other parts are received by the mediators and resold.

It is well known that Yukos utilized such schemes. The transactions of Yukos were realized through organizations founded in Mordoviia, Kalmykiia, Evenkiia, where preferential taxes were applied, and Cheliabinsk, Sverdlovsk, Nizhegorod Oblast, where closed cities with preferential privileges were located (*Vedomosti*, p. A1, January 15, 2004). Yukos utilized transfer prices to reduce its own sales and increase profits of those organizations located in the preferential tax zones. However, Article 40 of the Tax Code, enacted on January 1, 1999, prescribes some cases in which the tax authorities have the right to control prices used in transactions. According to Clause 1, Article 40, the prices for taxes are applicable to the prices of goods, works, and services, specified by transaction parties, supposing these prices correspond to the level of market prices. In order to monitor whether this premise is fulfilled, the tax authorities are given the right to check the legitimacy of transaction prices only in the following circumstances: (1) transactions between "interdependent" persons; (2) good exchange (barter) transactions; (3) foreign trade transactions; and, (4) transactions where the level of prices used by the taxpayer for identical goods fluctuates by more than 20 percent in either direction over a relatively short period of time. This regulation was introduced to deter evasion of taxes through transfer pricing. However, procedures to realize this regulation are opaque, so this regulation has not proven especially effective. Additionally, the definition of market prices is also ambiguous; therefore, the application of this regulation is problematic.

In case of Yukos, since summer 2003, several executives were arrested, which aroused suspicions concerning management, therefore, a tax inspection was carried out. The number of companies concerned with oil transactions in the Yukos group amounted to 22, and Yukos itself. Closed

JSC Yukos-M is included in 22 companies. Although Yukos held only 4 percent of its shares on December 22, 2000, the tax authorities regarded it as an affiliated company of Yukos and inspected it, because all sales of Yukos-M were brought about by the transactions with Yukos. Even if there are no relations with more than 20 percent of capital, some companies are considered as affiliates. For instance, in 2000, Yukos sold oil to Yukos-M at the price of 750 rubles per ton, then Yukos consigned Yukos-M to export the oil at the price of more than 4,000 rubles (*Vedomosti*, p. A1, July 23, 2004). As a result, the tax authorities calculated that the sum of the unpaid taxes of Yukos in 2000 amounted to 98 billion rubles, of which 47 billion rubles were unpaid taxes and the remaining was a surcharge and a penalty.

Concerning the case when a parent company *per se* plays a role in setting transfer prices, the instance of oil company Rosneft' is well known. In January 2001, the Moscow Arbitration Court acknowledged that the contract, in which a subsidiary of Rosneft', Purneftegaz sold 9.3 million tons of oil to Rosneft' at the price of 1,110 rubles per ton, was invalid (*Vedomosti*, p. B2, March 14, 2002). This suit was filed by shareholders of Purneftegaz, because this price was too low in comparison with market prices. The Court considered that the market price at that time was approximately 2,000 rubles per ton, therefore, this condition of the contract was disadvantageous to Purneftegaz.

Generally speaking, a domestic refinery purchases oil from an organization from the same group, an independent oil producer under contract, or a free market (*Neftegazovaia vertikal'*, p. 65, No. 12, 2000). According to the data investigated by this source, 24 refineries in 1999, the average price of oil within the internal transaction, that is, the average transfer price amounted to 600 to 800 rubles per ton, while the oil price was based on the independent oil producer, as 1,350 to 1,600 rubles per ton, and the oil price at the free market was 3,150 to 3,200 rubles per ton (ibid., p. 66). In case of Yukos, the free sale price of its subsidiary mining companies exceeded five times the transfer price of their affiliated refineries. Lukoil-West Siberia and KomiTEK supplied oil to unaffiliated refineries based on the direct contract at two times a higher price than their transfer prices. Although Surgutneftegaz set its transfer price three times higher than other oil companies' transfer prices, it added 17 percent of the transfer price to the price based on the direct contract, and 25 percent to

the price for a free market.[7] At this point, it should be noticed that the purchasing price of oil at refineries collected by the Statistical Service is based on a market price, however, the volume amounts to several percent of the real oil volume received by refineries. Concretely, the price was almost 3,300 rubles per ton both in 2000 and 2001 (Volkonskii and Kuzovkin, 2002, p. 23).

The reason why transfer pricing was widely utilized is that the sales of mining minerals were targets of taxation until the introduction of the mining tax on mineral resources, integrating using fee on underground resources, deduction for reproducing minerals and resource bases, and excise taxes on oil and gas in the beginning of 2002. In case of using fee on underground resources, the target of taxation was the sum of sales of mining minerals. In calculating deduction for reproducing minerals and resource bases, the target of taxation was the sales of minerals and resources received by mining companies. On the other hand, the mining tax on mineral resources is determined by the volume of mining oil. The tax rate is fixed against the volume of mining, therefore, the incentive to utilize transfer pricing to underestimate the sales has declined.

As for a profit tax, if a company can pretend to show smaller sales in its accounts, it results in reducing the profit tax. Nevertheless, it can be concluded that the incentive to underestimate sales has also faded, because in 2002 the tax rate of the profit tax was reduced from 35 percent (11 percent for the federal budget, 24 percent for the regional budgets) to 24 percent (7.5 percent, 16.5 percent respectively). In addition, since 2004, regional preferential privileges concerned with the profit tax have been restricted within 4 percent points of 24 percent. Of course, after the Yukos scandal, oil companies are exposed in public, therefore, it became difficult for them to utilize transfer pricing to save taxes.[8]

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[7] We should not that the ratio of materials supplied from the same group's mining companies in the total processed oil of refineries registers a difference of 45 percent (ONAKO) versus 100 percent (Yukos). Comparing the ratio of refineries supplied from their same groups' mining companies in 1996, these ratios of SIDANKO, Rosneft', and ONAKO amounted to only 20 to 30 percent (Kriukov, 1998, p. 201).

[8] Nevertheless, in other sectors, transfer pricing is utilized frequently. According to the report "about the estimation of the level of payment of taxes concerning a large scale of metallurgical companies," they intended to reduce taxes, utilizing processing on commission, transfer pricing, regional subsidies, and mediators registered in the preferential tax zones. For instance, it is indicated in this report that "North Steel" reduced taxes by 1.2 billion rubles, purchasing materials from the mediator registered in Kalmykiia. On the

As for the gas industry, transfer pricing was frequently utilized. *Vedomosti* stated that "Even Vlagimir Putin knew that the Gazprom exported gas at a price one-half to one-third the market price," then, President Putin asked the president of the Gazprom where the price difference had gone, in November 2001 (*Vedomosti*, p. A1, March 13, 2002). According to *Ekspert*, the Administration of Iamaro-Nenets AO received gas as a fee for using underground resources from the Gazprom, at the price of 2 to 3 dollars per 1,000 cubic meters and sold it to ITERA, holding deep connection with the Gazprom, at the same price (*Ekspert*, p. 14, No. 21, 2001). Although the Gazprom was damaged by one billion dollars in a year in this scheme, most of the loss flowed out through the ITERA, and some persons must have made a profit.[9]

Although the Gazprom seemed to utilize transfer pricing not only in the transactions of export, but also in the domestic operation, it is difficult to collect data concerning domestic transfer pricing.

To reinforce the regulations on transfer pricing, the Russian Federation Ministry of Finance has discussed the draft of the Law on the Control on Transferring Prices.[10] This draft was passed in the first reading of the Lower House in 2000, but failed to become law. Currently, the Ministry is still attempting to revise the draft for re-submission to the Diet. At the end of 2004, the Ministry proposed to the Government the draft of the Law, in which the rights to assume control over all the transactions among affiliated companies would be provided to the Ministry of Finance. Another method to deter transfer pricing is to introduce the tax payment system based on consolidated accounts (*Vedomosti*, March 25, 2004). In either case, because of transfer pricing, profits are redistributed among corporate groups, and therefore, it seems very difficult to estimate the real profits from the profits of individual firms.

From the point of "corporate groups' governance," it can be concluded that corporate groups strengthen their position through holding or even hoarding shares internally, i.e., the insiders amass as many shares as

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other hand, the utilization of transfer pricing to avoid an excise tax has been at issue in these years, for example, in the tobacco sector. The excise tax on oil *per se* was abolished in 2002.

[9] In this scheme, the payment in goods to the Administration was forbidden in 2001.

[10] In Kazakhstan, the Law on the State Control on the Application of Transfer Prices was enacted in 2001. In 2003, the joint instructions of the Tax Committee under the Ministry of Finance and the Customs Control Service were published.

possible which effectively diminishes the potential of outsiders to have any influence on corporate strategy. However, it is meaningless to distinguish insiders from outsiders, at least on a superficial level. Individuals and firms regarded as outsiders include stakeholders who could have the support of the insiders, like managers. Therefore, it is necessary to distinguish between what might be considered superficial "insiders' ownership" and what in actuality is genuine "insiders' control." Without making unambiguous distinctions between "ultimate owners" and "beneficial owners," arguments about the challenges and problems associated with "corporate groups' governance" are very much weakened.

As a result of considering corporate governance as only a problem concerning each firm, injustice related to corporate groups is overlooked. Minority shareholders are pressured in various ways, and the profits of individuals controlling corporate groups and the profits of corporate groups as a whole are increasing. This is a history of Russian firms in the process of conversion from a socialist economy to a capitalist one. At the beginning of grouping firms, the dilution of shares could avoid being controlled by a third party, and their integration was stimulated by the mutual holding of shares and by holding the shares of parent companies by affiliates (The Minority Squeeze, 2004, p. 40). In addition, "reverse stock split" could prevent investors from purchasing shares by increasing the price of "one share" by the integration of several shares. Utilizing transfer pricing, corporate groups could redistribute profits among them, evade taxes, and manipulate share prices of specific firms. This is the most crucial issue in relation to corporate governance.

From the point of "corporate groups' governance," the Law on Holding Companies, the Law on Affiliated Companies, and the Law on Transferring Prices are very important in establishing "corporate groups' governance." However, even now, neither of the laws has been enacted.

As for the draft of the Law on Holding Companies, President Putin vetoed it in 2000.[11] In 2001, another draft was proposed but later rejected by the Upper House. Although the draft was re-submitted to the Lower House at a later time, the draft has not finished its run through committee procedures as of October 2004. Therefore, at this time, holding companies are regulated by the appendix of the Presidential Decree of November 16,

[11] The draft of the Law on Holding Companies presented to the third reading of the Lower House in 1999 can be seen in Gorbunov, 2003, pp. 197-206.

1992, called the "Temporary Provisions concerning Holding Companies Transferred from State-Owned Enterprises to Joint Stock Companies."

The Law on Affiliated Companies has also not been established. According to Articles 105 and 106 of the Civic Code, if a firm holds more than half of the shares of another firm, the latter firm is called a subsidiary firm, and if it holds more than 20 percent of shares, it is called a "dependent" firm (*zavisimoe obshchestvo*). The *zavisimoe obshchestvo* can be also translated as an "affiliated" firm. Therefore, dependent or affiliated companies include not only subsidiary firms, of which more than 50 percent of shares are held by their parent firms, but also other firms, of which 20 to 50 percent of shares are held by their parent companies. Besides, firms controlled by the same managers can be seen as affiliated companies (*Kommersant'*, October 1, 2004). According to Article 20 of the Tax Code, "dependent" is defined as more than 20 percent commitment of an organization to other organizations directly or indirectly. Not only a direct relationship, but also indirect ones are recognized as "dependent." However, the relationship between the existence of a "dependent" relationship and the responsibility to pay taxes is ambiguous. Therefore, it is necessary to define affiliated companies clearly and reinforce regulations on corporate groups.[12]

[12] There are other factors to consider about "corporate groups' governance." Radygin argues that one of the dominating motives of a "beneficial owner" in concealing information of the real owners of some share is protection of assets acquired recently and far from always completely legally (Radygin, 2003, p. 5). Russian companies frequently use trusts for purposes of minimizing their tax exposure. For instance, a "beneficial owner" located in a country with a high taxation regime transfers title of his property to a trustee resident in an offshore zone. In this case, the trustee would pay property tax at lower rates, and the "beneficial owner," in turn, would pay taxes only on profits gained as a result of using his property. Apparently, the reason offshore companies were established was to conceal profits and capital, evade taxes, and protect assets. All things considered, it is true that offshore companies can hide "beneficial owners." Hence, from the point of corporate governance, the regulations on the relationship between offshore companies and Russian residents or native firms should be strengthened. One of the regulations is introducing the legal requirement of beneficial ownership information disclosure by offshore companies (ibid., p. 5). Offshore companies are concerned with trust. Trust schemes appear to follow a prescribed path: property to be transferred in trust is first passed over to an offshore company, after which the shares of that company are placed in trust (ibid., p. 11). The concept of trust appeared in the Law on Banks and Banking Operations in Russian Republic of the Soviet Union, established in December 2, 1990. In Article 5 of the Law, "trust management" (*doveritel'noe upravlenie*) means the operation of accepting money and controlling

To disclose "beneficial owners," that is, to establish "corporate groups' governance," the regulations on information disclosure are very important. According to Article 30 of the Law on the Securities Market, an issuer of securities must disclose the list of holders who have more than 20 percent of its share capital and juristic persons which have been issued more than 20 percent. Every holder who has more than 20 percent of any class of securities also must disclose the information about their securities. If more than 5 percent of shares over the crucial 20 percent are increased or decreased, the holder is also obligated to disclose the information of his or her securities. The information of a newcomer who holds more than 25 percent of the shares should also be disclosed. In the protocol of securities, the information about persons holding no less than 5 percent of share capital and the list of all juristic persons holding more than 5 percent of share capital must be disclosed (Article 22). There are other regulations on information disclosure such as the resolutions of the Federal Committee of the Securities Market, the Law on Violation against Administrative Laws (Article 15.19), and the Law on Regulations against Monopolistic Activities and Competition in Commodity Market (Article 18), established on March 22, 1991. However, currently, information disclosure has not been sufficient enough to expose the "beneficial owners."

CONCLUSIONS

The policy to disclose "beneficial owners" and "ultimate owners" is the foundation from which to establish "corporate groups' governance." Radygin proposes the following concrete measures: (1) clarification of the

securities on the basis of the trust of a client. In the Decree of the President on July 1, 1992, the expression of "trust" had appeared in Clause 6. On October 24, 1993, the Presidential Decree on Beneficial Ownership (trust) was published. At the beginning of 1994, the Russian Federal Fund of Property concluded the agreements with trust contracts, which amounted to approximately 80. The procedures and conditions of trust management of property were established by Article 209 of the Civic Code, enacted from January 1, 1995. The order of trust management of credit organizations and banks is regulated by the Law on Banks and Banking Operations and the Instruction on the Order of Exercising Trust Management Transactions and Accounting for Such Transactions by Credit Organizations in the Russian Federation (ibid., p. 19). However, even now the absence of the concept of trust in Russian law is crucial for purposes of identifying "beneficial owners" (ibid., p. 19). This is one of the reasons why "corporate groups' governance" has been fully developed in Russia.

legal concept of "beneficial owners;" (2) the strict implementation of laws and regulations concerned with trusts; (3) making assets and the control of shares transparent; (4) faithfully adhering to the Law on Firms and the Anti-Monopolist Law; (5) restricting offshore transactions through regulations on banks; and, (6) introducing International Accounting Standards and Generally Accepted Accounting Principles (Radygin, 2003, pp. 24-28).

To establish "corporate groups' governance," not only policies of information disclosure, but also the establishment of the following laws is crucial: (1) the Law on Holding Companies; (2) the Law on Affiliated Companies; and, (3) the Law on Transfer Pricing. Lastly, the "reality" of the Russian economic climate should be scrutinized, and then measures for managing it accordingly should be taken.

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Table 1. Main Laws Related to Corporate Governance and Protection of Ownership, Which Were Revised or Enacted during 2000 and 2003

Laws	Contents	Plus	Minus
Revision and Supplements of the Law on JSCs (August 7, 2001, March 21, 2002, October 31, 2002) and Revision of the Law on Protection of Rights and Legal Interests of Investors in Securities Markets (December 9, 2002)	Prohibition against issuing shares for a part of shareholders. The compulsory integration of shares as the method of throwing minorities out is restricted. The proportional exercising of the rights of shareholders on the occasion of reorganization (separation) is introduced. The procedures for controlling organizations are specified.	Most methods which allowed for discrimination against the rights of shareholders were prohibited.	Revision was delayed for several years. Important issues such as clarification of rules of merger and regulations of division of shares are unresolved.
Revision and Supplements of the Law on the Securities Market (December 28, 2002)	New requests for information content to be disclosed by the issuers. Simplification of regulation procedures for issuing securities of the closed JSCs. Introduction of responsibility for price manipulation. Regulations on option trading.	Partial improvement of opaque laws and regulations	Unfair expansion of full power of regulation authorities. Introduction of compulsory utilization of financial consultants.
New Law on Insolvency (Bankruptcy) (October 26, 2002)	Strengthening protection of the rights of creditors (first of all, the state). Expansion of the sphere of the rights of the owners in good faith, who own firms in debt in the procedures of bankruptcy. Alteration of the status of arbitration receivers and governmental institutions. Introduction of new proce-dures for sound finance.	Establishment of obstacles to hostile mergers, utilizing the mechanism of bankruptcy.	Retaining theft of ownership in an altered way and conditions to corruption.
Law on Investment Funds (November 29, 2001)	Legal basis for activities of investment funds, their controlling companies, and special depositors is prescribed.		It is necessary to develop rules of trust by closed and open investment funds and investment funds with holdings.

Law on Privatization of Public Assets (December 21, 2001)	Alteration of a set of methods enabled to abolish minority holdings and unemployed capital.	In the sphere of abolishment of stocks of uncontrolled ownership, the basis to realize the concept of the control of federal assets (2003) has been brought about.	It is necessary to show that new laws are effective in a few years and to adopt the law on public assets.
Law on Public Unitary enterprises (November 14, 2002)	The level of protection of national interests is improved drastically.	Stimulating refusal of the form of organizations and rights of unitary enterprises.	Ten years lag (this issue has been discussed since 1993. Notes concerning this law had already existed in the Civil Code in 1995).
Revision of Criminal Code (2001)	This revision lays criminal responsibility on leaders of JSCs. This responsibility involves the violation of protection of rights and interests of investors.	These regulations concerned with criminal responsibility have original significance in relation to rights accorded in Russia.	
New Code on Violation of Administrative Law (December 30, 2001)	This code includes the regulations on relative responsibility in the sphere of corporate governance in securities markets.		Absence of transparent measures in evaluating sanctions in violation of the law.
Code of Arbitration Procedures (enacted in September 1, 2002) and Code of Civic Procedures (enacted February 1, 2003)	Adoption of dual system in the trial of lawsuits concerning firms (Arbitration courts and general courts).		Collision with jurisdiction in the sphere of protection of the rights of shareholders is unresolved. Proper alteration to the Code of Arbitration Procedures is necessary.

Sources: Radygin, et al., 2004, pp. 278-280.

Table 2. Structure of Ownership in Russia, Based on Sample Investigation

	Afanas'ev, et al. [1]			Worldbank Sample [2]	Radygin, et al. [3]		Starovoitov [4]		Dolgopiatova [5]			Spenger [6]
	Jul.–Aug., 1994	Dec., 1995 –Jan., 1996	1996	1994	Apr., 1994	Jun., 1995	1995	1997	1995	1998	2000	1999
Insiders	**66**	**58**	**55**	**66.1**	**62**	**56**	**58.5**	**51.6**	**49.8**	**40.1**	**39.3**	**46.2**
Managers	22	15	12	19.6	9	13	10	12.1	7.8	9	9.5	14.7
Employees	44	43	43	46.2	53	43	48.5	39.5	42	31.1	29.8	31.5
Outsiders	**-**	**-**	**26**	**18.9**	**21**	**33**	**31.7**	**41.3**	**37.9**	**49.3**	**49.6**	**42.4**
Individuals	6	8	8	5.9	-	-	9.6	13.2	13.5	18.6	19	18.5
Non-financial firms	-	-	3	6.7	-	-	8.1	12.9	12	13.9	14.9	13.5
Banks	-	-	2	1	-	-	1.6	1.2	1.6	1.3	1.2	1
Investment funds	5	5	5	4.5	-	-	7.2	4	9.0[a]	11.8	11.2	3.9
Foreign investors	-	-	2	0.4	-	-	1.7	5.1	1.8	3.7	3.3	2
Holding companies/ Investment firms/Trust	-	-	6	-	-	-	3.5	4.9	-	-	-	3.5
State	**12**	**9**	**9**	**15**	**17**	**11**	**9.5**	**6.5**	**9.7**	**8.4**	**8.9**	**7.1**
Others	**11**	**20**	**10**	-	-	-	**0.3**	**0.6**	**2.6**	**2.2**	**2.2**	**4.3**
The number of samples	88	312	259	235	-	-	138	139	277	277	277	139

Table 2. (*continued*)

	Bevan, et al. [7]	Radygin & Arkhipov [8]	Aukustionek & Kapeliushnikov [9]				Radygin, et al. [10]		Dolgopiatova [11] [d]		
	2000	2000	1995	1997	1999	2001	1999	2002	2000	2001	2002
Insiders	**62.3** [b]	**27.6**	**54**	**52**	**50** [c]	**50** [c]	**37.8**	**32.7**	**52.5(-15.0)**	**48.2(-6.6)**	**31(-14)**
Managers	17.7	7.2	11	15	15	19	9.4	17	17.8(4.9)	21.0(9.8)	9(1)
Employees	34.5	20.4	43	37	34	28	28.4	15.7	34.7(-19.9)	27.2(-16.4)	22(-15)
Outsiders	**32**	**55.4**	**37**	**42**	**42**	**42**	**46.5**	**55.4**	**41.8(21.6)**	**43.9(7.8)**	**41(7)**
Individuals	-	15.2	11	15	20	22	22.2	27.4	19.3(9.6)	25.3(13.5)	14(2)
Non-financial firms	-	15.2	16	16	13	12	20.3	25.2	15.1(7.1)	11.3(-3.7)	22(9)
Banks	-	2.2	1	1	1	1	1.1	1.3	4.5	0.8	2(1)
Investment funds	-	4.4	4	4	3	3	-	-	-	6.5	1
Foreign investors	-	4.7	1	2	2	0	2.9	1.5	2.9(2.6)	0.4	2
Holding companies/ Investment firms/Trust	-	6.2	4	4	3	4	-	-	-	-	-
State	**5.7**	**12.8**	**9**	**7**	**7**	**7**	**11.4**	**8.2**	**5.7(-6.6)**	**7.9(-1.2)**	**28(7)**
Others	**-**	**4.2**	**-**	**-**	**-**	**-**	**4.3**	**3.7**	**-**	**-**	**-**
The number of samples	364	201	136	135	156	154	60	60	more than 350	more than 150	-

Notes: [a] Including investment firms. [b] The sum of managers and employees amounts to 52.2 percent. It seems that this figure includes other factors such as affiliated companies, but details are unknown. [c] Including holding shares of subsidiary firms (in 1999, 1 percent, in 2001, 3 percent). [d] Figures in parentheses express the changing rate (percent points). In 2000, the rate is related to the period during 5–8 years, in 2001, it is concerned with the time during 7 years, and in 2002, the rate expresses the result of 6 years. The figures for individuals include other factors. The figures for the bank in 2000 contain investment funds. In 2002, the samples are limited only to military firms.

Sources: [1] Afanas'ev, et al., 1997, p. 87. [2] Earle and Estrin, 2001, p. 183. [3] Radygin, et al., 1995, p. 53. [4] Starovoitov, 2001, p. 63. [5] Dolgopiatova, 2001, p. 47, Dolgopiatova, 2002, p. 6. [6] Sprenger, 2001, p. 4, the original is Kapeliushnikov, 2000. [7] Bevan, et al., 2001, p. 19. [8] Radygin and Arkhipov, 2002, p. 44. [9] Aukutsionek and Kapeliushnikov, 2001, p. 11. [10] Radygin, et al., 2004, p. 225. [11] Dolgopiatova, 2003, p. 47.

Table 3. Concentration of Ownership (survey of 213 firms)

(percent of total capitals)

	1995		1998		2000 (estimate)	
	Average	Mean	Average	Mean	Average	Mean
The largest share-holder	26.2	22	27.6	23	28.8	24.2
1st–3rd largest shareholders	40.4	40	44.5	44.4	46.5	46.3

Sources: Dolgopiatova, 2001, p. 47.

Table 4. Ranking of Employment and Sales among 22 Corporate Groups

Rank by Employ-ment	Employment	Sales (1,000 rubles)	Managed by	Organization	Rank by sales
1	168,966	64,825,452	Deripaska	Base Element	11
2	168,554	202,629,008	Abramovich, Shvidler	Sibneft'/Millhouse	2
3	167,223	111,593,552	Kadannikov	Avtovaz	7
4	143,437	70,276,496	Popov, Mel'nichenko, Pumpianskii	MDM	10
5	136,868	474,973,216	Alekperov, Maganov, Kukura	Lukoil	1
6	121,901	78,224,152	Mordashov	Severstal'	9
7	111,692	137,194,080	Potanin, Prokhorov	Interros	5
8	101,091	52,412,024	Abramov	Evraz	13
9	94,047	121,121,744	Veksel'berg, Blavatnik, Balasskul	Renova/ Access In-dustries	6
10	93,271	149,226,576	Khodorkovskii, Lebedev	Yukos	4
11	74,933	33,221,580	Makhmudov, Kazitsin	UGMK	16
12	65,325	163,129,392	Bogdanov	Surgutneftegaz	3
13	56,892	57,199,712	Rashinikov	Magnitogorsk steel	12
14	53,932	30,854,502	Zuzin	Mechel	17
15	47,326	38,951,240	Lisin	Novolipetsk steel	15
16	41,698	20,439,996	Smushkin, Zingarevich	Ilim Palp	19
17	41,046	40,611,844	Takhaudinov	Tatneft'	14
18	38,490	106,713,016	Fridman, Khan	Alfa	8
19	35,935	15,113,239	Ivanishvili, Gindin	Metalloinvest	21
20	35,384	10,265,729	Bendukidze, Kazbekov	OMZ	22
21	20,272	26,946,746	Evtushenkov, Novitskii, Gotscharuk	Sistema	18
22	12,704	20,254,446	Iakobashvili, Plastinin, Dubinin	Vimm Bill' Dann	20
total	1,830,987	2,026,177,742			

Sources: Vsemirnyi bank, 2004, p. 12.

Table 5. Main Places Applied for Preferential Tax Treatment

1994	Established a Free Economic Zone《Ingushetiia》, based on the resolution of the Government of the Russian Federation on June 19, 1994
1995	Established a Free Economic Zone《Kalmykiia》[a]
1996	Began to supply preferential tax treatment to ZATO[b]
1997	Established a Free Economic Zone《Uglich》
	Established a Free Economic Zone《Altai》, based on the Law on the Free Economic Zone in Altai krai
	Introduced preferential treatment to Smolensk
	Abolished a Free Economic Zone《Ingushetiia》
2001	Abolished preferential tax treatment to ZATO[b]

Notes:
[a] Other information indicates that it was established in 1994 (Ushakov, 2002, p. 107).
[b] As for ZATO, see Brock, 1998, 2000.

Sources: *Ekspert*, p. 57, No. 45, 2003 and Ushakov, 2002, pp. 86, 108.