

## SESSION IV: NON-FINANCIAL DISCLOSURE AND ACCOUNTABILITY

### *ENFORCEMENT PROBLEMS RELATING TO EXISTING INFORMATION DISCLOSURE LEGISLATIVE REQUIREMENTS*

Presentation on by

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<sup>1</sup> Our preceding two reports were likewise devoted to information disclosure issues, dwelling in detail both on general problems encountered in the legal regulation of information disclosures by Russian issuers of securities and on the more specific matter of legal regulation for information disclosures about affiliates.

The principal problem still is the lack of an efficient statutory system for information disclosures. Relevant provisions are to be found in different regulatory acts, which are, at that, often contradictory, making it difficult to enforce them in practice. The fundamental legal act governing information disclosures connected with securities is the Federal Law "*On the Securities Market*", but its corresponding clauses, alas, also stand no criticism. Suffice it to mention that two of its articles (Article 23 and Article 30) dealing with issuers' disclosures about their securities directly contravene each other.

Just a few months have passed since our previous report. The time has been too short for the drafting and enactment of new regulatory documents capable of improving the information disclosure situation in any radical way, but still enough to spotlight those enforcement issues which brook no delay. Therefore, we will discuss only certain aspects of non-financial information disclosures, which have posed enforcement problems. These include, but are not limited to, issues relating to the provision of information about sales or purchases of "major shareholdings", a joint stock company's officers, and some corporate events.

#### **Information disclosures about purchases of "major shareholdings"**

The practical application of regulatory requirements regarding information disclosures about "major shareholders" is fraught with particular difficulties. In addition to general problems engendered by the existence of a great many legal acts on these issues, the enforcement of their relevant clauses has revealed a dearth of understanding between these acts on what should be treated as a "major shareholding".

Some (like the *Issue Standards*) stipulate that disclosures about "major shareholders" should be limited to information about voting shareholders, others (the *Securities Market Law* and the *Regulations on the Procedure for Information Disclosures on Material Facts, Acts or Events Affecting Financial and Business Activities of Emissive Securities Issuers*) insist that all shareholders must be disclosed, whether voting or not, while still others require that such disclosures should extend even to those parties who can dispose of votes only indirectly, in particular, by being able to influence the company's governance as a trust manager or in another capacity (with information disclosures about affiliates to take due account of the latter's definition as set out in the Federal Law "*On Competition and on the Limitation of Monopolistic Activities on Commodity Markets*").

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<sup>1</sup> The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its member countries. This paper is subject to further revision.

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There also is a lack of unanimity on the number of votes (the ownership interest in the charter capital) to be deemed as material from the standpoint of their holder's impact on the company's decision-making and, hence, on the instances where investors have to be advised accordingly. The *Securities Market Law* requires that an offering prospectus should reveal information about shareholders representing 5 or more percent of the charter capital (Article 22), whereas quarterly statements (Article 30) and reports on material facts (Article 23) should disclose information about shareholders owning 20 or more percent of the charter capital.

The different approaches not only complicate the enforcement of requirements governing the disclosure of information about "major shareholders", but also prevent the attainment of the very objective which was sought by the lawmakers when establishing such requirements. As a result, investors are unable to obtain adequate information about the parties exercising influence on resolutions made by a joint stock company and about changes to the extent of such influence. The practice of disclosing information about "major shareholders" has demonstrated the need to amend existing legislation so as to remove contradictions and harmonize requirements for such disclosures. It is imperative, in particular, to provide definite answers, at long last, to the following questions.

*1. What kind of information provides the investor with the better grounds to make an objective assessment: information about the ownership interest held by a party in the charter capital or that about the number of votes the same party can use for decision-making purposes?* Quite obviously, information about the stakes held by various parties in the charter capital, far from really helping the investor, may well confuse him. Preference shares, for example, do not carry voting rights in most cases, but there may also exist preference shares, which carry several votes each, and the number of such votes is far from always linked to the nominal value of the shares. Information about the parties in a position to be able to sway decision-making by a company is most relevant to the investor where he needs to have an objective view of the situation at the company. However, such information should cover both those with direct rights to dispose of votes and those with indirect powers to do the same.

These include both the owners of voting shares and those who have acquired voting rights:

- on the basis of contracts with voting shareholders, including contracts of trust management and other agreements granting them rights to vote, as permitted by the respective shares, at their own discretion;
- as a result of control over a legal entity owning voting shares;
- through contracts with voting shareholders to exercise a concerted common policy in the company's governance by exercising the corresponding voting rights; and
- those who have acquired voting rights by accepting shares on collateral.

*2. The ownership of which percentage of votes is of material significance in terms of influencing the company's governance?* This question ought to be answered proceeding from joint stock company legislation which sets out requirements for the quorum during general meetings and for the number of votes required to take decisions vital to the company (for example, those to amend the charter, to restructure or wind up the company, to enter into major transactions, etc.). Since a meeting is deemed validly convened if attended by shareholders representing more than one-half of the outstanding voting shares and a three-fourths' majority vote is needed to take the more important decisions, the parties actually able to influence such decision-making include those controlling at least 10 percent of the votes. This is especially so as it is precisely such shareholders that may initiate extraordinary general meetings.

Another problem brought forth in the process of applying regulatory requirements for information disclosures about "major shareholders" consists in the fact that it is impossible to comply with such requirements not only practically, but also theoretically.

The obligation to disclose information about "major shareholders" is borne by the issuer of securities. Article 22 of the *Securities Market Law*, for example, binds the issuer to reveal information

about the owners of at least 5 percent of its charter capital and Article 30 of the same Law obliges the issuer in its quarterly statements to report "the inclusion in the issuer's register of any party owning more than 25 percent of any separate class of its emissive securities", while Clause 12 of the *Regulations on the Procedure for Information Disclosures on Material Facts, Acts or Events Affecting Financial and Business Activities of Emissive Securities Issuers* requires that issuers notify the FCSM and publish reports about the acquisition by any party of an equity of more than 5 percent of their charter capital, as well as any changes in the size of such equities that are divisible by 5 percent.

Furthermore, the issuer is obliged to make such disclosures within 5 business days of the respective acquisition or change. The acquisition or change in question is deemed effected on the date when the corresponding record is made in the company's share register or when the corresponding transaction is executed on the deposit account. Whereas the issuer can indeed obtain and report the required data concerning changes in the register on time, subject to the inclusion of appropriate clauses in its contract with the registrar, there are only two cases in which the issuer will be able to obtain information about changes in the ownership of securities recorded on deposit accounts and then only under a favorable set of circumstances.

The first case is where the purchaser of a "major shareholding" simultaneously becomes affiliated to the issuer and, in a law-abiding fashion, performs the duty to advise the company of the acquisition within 10 days, as required by Article 93 of the Federal Law "*On Joint Stock Companies*".

The second is where the purchaser of more than 20 percent of shares (or the party whose ownership interest changed in size by an extent divisible by 5 percent) notifies the FCSM accordingly, as required by Article 30 of the *Securities Market Law* and the FCSM, for its part, relays the news to the issuer as a favor.

It is apparent, therefore, that even the most good-faith issuer is unable in all too many instances to discharge its statutory information disclosure duties, including the obligation to publish information about "major shareholders". This notwithstanding, the issuer may be held administratively liable for failing to observe the procedure and deadline set for disclosing such information pursuant to Article 12 of the Federal Law "*On Protection of Rights and Lawful Interests of Investors*". This situation is to the detriment of investors, since there is no way they can get the information needed to take an investment decision, and to issuers who will be deemed law-breakers despite all their efforts to the contrary, as they will only be able to make the required disclosures either late or partially, which will make it possible subsequently to accuse them of providing inaccurate information.

The above problem can only be resolved by amending legislation to oblige both direct and indirect owners of shares themselves to notify the issuer of purchases of any "major shareholdings" and changes to the extent of their influence on the company's governance. Such obligation should be accompanied by a time limit, as well as penalties for non-performance.

### ***Information disclosures about company's officers***

Regulatory acts include the following among persons about whom investors are entitled to be informed and the company is obliged to provide information:

- individual executive authority;
- members of the collective executive authority; and
- directors.

Information about them is provided both in offering prospectuses and in quarterly statements.

It includes the number of shares they own in the company, the ownership interest they hold in its charter capital, as well as in its subsidiary and dependent companies, and the positions the people concerned have held over the past 5 years, including secondary executive jobs. Both offering

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prospectuses and quarterly statements are also required to report all types of compensation disbursed by the issuer to each of such officers, including salaries, bonuses, commissions and in-kind rewards.

In addition, the company is obliged to treat as material facts and report purchases by such persons of its shares or equities in its subsidiary or dependent companies, as well as any changes in such shareholdings and equities.

The practical implementation of the above requirements has likewise encountered certain problems, some due to internal contradictions in the *Securities Market Law*. Here is just one example. Articles 22 and 23 of the Law provide for requisite information to be disclosed in the form of offering prospectuses and reports on material facts. However, offering prospectuses are required to reveal information about any stakes held by the above officials in the issuer's charter capital, while material fact reports may be limited to naming the owners of only the larger equities which represent more than 20 percent of the issuer's charter capital. This contradiction is partially removed by regulatory acts of the FCSM, which require the disclosure of any share purchases by such officers and of any changes in their respective shareholdings. The existing situation, however, can hardly be regarded as satisfactory, as there is always the risk that the corresponding acts of the FCSM will be ruled as going contrary to law.

The same risk exists in relation to those acts of the FCSM which require disclosures about remuneration paid to company officers, especially after the strong criticism voiced against these provisions last year and early this year. The critics argued that the requirements concerned are inconsistent with the Russian Constitution, since information about compensation is allegedly one that concerns a person's private life whose immunity is guaranteed by Article 23.1 of the Constitution. Therefore, it is exceptionally important for nothing less than a law to require that joint stock companies disclose information about compensation paid to their officers.

***Information disclosures about corporate events***

The *Securities Market Law* and regulatory acts of the FCSM contain some provisions requiring information disclosures about corporate events such as general shareholders' meetings and company restructuring. These provisions, however, are not sufficient for investors to be kept adequately informed about corporate developments of relevance to them.

This is especially true in the case of information regarding company restructuring. The problem has assumed a particular urgency lately after the Russian Supreme Court last April invalidated Clause 6.7 of the *Issue Standards Applicable During the Restructuring of Commercial Organizations* as contradicting law. The abolished clause required that where a company was restructured by way of a split-up or split-off, each shareholder should be left with an integer number of shares carrying the same rights as were evidenced by such shareholder's holdings in the restructured company, which should be in proportion to his interest in that company.

The invalidation of the clause has lifted the barrier to the dilution of shareholders' equities or to their stripping of rights, since the *Joint Stock Company Law* allows for the possibility of disproportionate share distributions during company restructuring and for the conversion of shares in the company undergoing restructuring into securities other than shares, for example, into bonds. Unfair conversion rules may substantially injure the interests of shareholders in such companies. In practice, minority shareholders are often forced to join bankrupt companies and creditors are unable to obtain their dues.

The situation is compounded by the fact that the law does not require that shareholders be provided with information about the rationale behind a planned restructuring, the methods employed to value the assets of companies involved in such restructuring, and other information which could be helpful for investors in deciding whether to purchase shares in such companies. Shareholders are only entitled to see those documents which are submitted for their approval (merger or consolidation agreement, deed of transfer, and divided balance sheet). Moreover, it is only as a gesture of goodwill that

a company's governing bodies make these documents available to shareholders for viewing prior to the relevant general meeting. In accordance with Article 52.4 of the *Joint Stock Company Law*, for example, neither a merger or consolidation agreement nor divided balance sheets and deeds of transfer are on the list of materials to be provided to shareholders at all times as part of preparations for a general meeting. Regrettably, the FCSM, too, has not taken advantage of its right to extend such list and close the unfortunate statutory lapse.

Therefore, it is crucial during company restructuring for information disclosures to be made to an adequate extent and as early as possible, for example, upon the board of directors' decision to raise the issue of company restructuring before the general meeting, which should necessarily describe the proposed procedure and terms for the conversion of shares, so as to ensure that information about the contemplated reorganization be provided promptly and in full.

In conclusion, we would like to touch on yet another problem having to do with Russian issuers' reluctance to share information. Whereas abroad issuers provide information voluntarily, being aware of its significance for the attraction of investments, Russian issuers often seek, under all manner of pretexts, to disclose as little information about their operations as possible. In these conditions, legislative requirements concerning information disclosures should be clear and comprehensive enough to leave no loopholes to be used to withhold that information which may be of material significance to investors.

The practical application of Russian legislative provisions on non-financial information disclosures is often tantamount to wandering in a maze of legal riddles and this compels the FCSM to issue regulatory acts designed to iron out contradictions between different laws. Therefore, it is very important in the regulation of information disclosures to make it absolutely clear which issues are subject only to laws and which may be decided by other regulatory acts. The system in place for non-financial information disclosures should be readily understandable, relatively inexpensive, and accessible to investors. Disclosures should be limited to only that information which is of material importance to investors.

The International Standards for Information Disclosures, which have been adopted by IOSCO and are applicable to international offerings and primary listings of foreign issuers, contain a generally recognized set of standards for disclosing non-financial information. They can be used as guidance in drafting amendments for those articles of the *Securities Market Law* which govern information disclosures, helping to ensure that the relevant Russian principles are brought into line with the international standards and to facilitate international securities transactions executed by Russian companies to such standards.

In conclusion, we would like to note that despite problems existing in the legal regulation of information disclosures and in the enforcement of related statutory requirements, there is a greater awareness in Russia these days of how important information disclosures are as an indispensable condition to the exercise of shareholder and investor rights and interests, and as a prerequisite for the creation of civilized capital markets in the country. This is borne out by the following quote from Decision No. 38-O issued by the Russian Constitutional Court on March 2, 2000: "Information disclosures about owners of registered securities are an expression of the fundamental operating principle of a modern capital market - information transparency – whose observance is a vital guarantee for upholding the rights of investors in securities and, most notably, the owners of such securities themselves."