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# Compliance with the Sarbanes-Oxley Act of 2002: challenge for Russian Corporate Governance

## **Abstract**

[Extract] The transitional period from socialism to capitalism in Russia gave birth to business enterprises with different organisational forms. These included partnerships, private and limited liability companies, closed and public joint-stock companies and joint ventures. Soon, we will see the completion of this period of formation and the concomitant accumulation of capital, which has been characterised by legally disputable privatisation of state property and its further redistribution. All this process in the Russian economy led to the foundation of huge corporations - strong financial and production groups of companies and holdings with high levels of capitalisation, which control the main fields of industry.

## **Keywords**

Russia, corporate governance, Sarbanes-Oxley Act of 2002,

# COMPLIANCE WITH THE SARBANES-OXLEY ACT OF 2002: CHALLENGE FOR RUSSIAN CORPORATE GOVERNANCE

by Pavel DIDENKO<sup>1</sup>

## Introduction to the problem

The transitional period from socialism to capitalism in Russia gave birth to business enterprises with different organisational forms. These included partnerships, private and limited liability companies, closed and public joint-stock companies and joint ventures. Soon, we will see the completion of this period of formation and the concomitant accumulation of capital, which has been characterised by legally disputable privatisation of state property and its further redistribution. All this process in the Russian economy led to the foundation of huge corporations - strong financial and production groups of companies and holdings with high levels of capitalisation, which control the main fields of industry.

The developing Russian economy could not have avoided the process of integration into the international market. Already Russian companies are attempting to run their businesses according to international standards.<sup>2</sup> A major reason pushing corporations to orient to the "overseas experience" is the need for access to foreign capital markets. Potential foreign investors look at several key factors including the economic and political situation, the legal environment in the company's home country, and the latest trends in the relevant industry. These factors are out of the corporation's control, but other factors are attached to the company. These are their financial status, business results, future strategy of development, and corporate governance system. It is essential for investors to know how their interests will be safeguarded. Positive financial results are of great significance, but non-compliance of a company's corporate governance system with best international practice will still raise investors' doubts.

The EU and the US markets are strategically the most important for Russian companies, apparently. Most Russian companies opt for public offering of their equities on the London Stock Exchange (LSE) and the New York Stock Exchange (NYSE).<sup>3</sup>

Until recently, the latter was the focus of almost all companies seeking foreign listing. There seemed to be a prestige factor attached to New York and, for Russian companies, London tended to have the more onerous disclosure requirements. Moreover, in contrast to European-based emerging market investors, many US investors only buy stocks listed in the US. The NYSE, as the world's biggest exchange, gives a unique access to the huge US investor base.

Notwithstanding these factors, everything turned upside-down for foreign companies after

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<sup>2</sup> See, eg, *Independent Director Activities on the Boards of Russian Companies*, Survey conducted by Independent Directors Association in collaboration with Investor Protection Association and Ernst & Young CIS Limited, March 2002; <[http://www.corp-gov.ru/upload/file/\(1\)General\\_Survey\\_eng.doc](http://www.corp-gov.ru/upload/file/(1)General_Survey_eng.doc)> at 19 June 2005.

<sup>3</sup> See Ernst & Young Global IPO Survey — 2004; <[http://www.ey.com/global/download.nsf/Russia\\_E/EY\\_Global\\_IPO\\_Survey2004/\\$file/EY\\_Global\\_IPO\\_Survey\\_2004.pdf](http://www.ey.com/global/download.nsf/Russia_E/EY_Global_IPO_Survey2004/$file/EY_Global_IPO_Survey_2004.pdf)> at 19 June 2005.

the recent fraud cases in the US, and the complications that followed with the passing of the *Sarbanes-Oxley Act* of 2002 (SOX). It significantly changed the regulatory landscape for companies that participate in the US capital markets. With the stroke of a pen, the US Congress imposed major corporate governance and disclosure reforms and created an entirely new regulatory scheme for the accounting profession. Now that the US Securities and Exchange Commission (SEC) has adopted final rules implementing most of the provisions of the Act, long-term consequences can be better evaluated.

The Enron and Anderson scandals have led to companies comparing the LSE and the NYSE on their merits. For example, after adoption of the SOX, German *Porsche* and Japanese *Daiwa Securities Group* and *Fuji Photo Film* said that they postponed plans to issue American depository receipts (ADR) on the NYSE. The British *Benfield Group*, having intended to place ADR in New York, eventually brought an Initial Public Offering (IPO) of US\$260 million in London, fearful of rapidly changing laws in the USA.

As for Russian companies, *LUKOIL* - one of the world's biggest vertically integrated companies for production of crude oil and gas - opted for the LSE and issued ADR covering 5.9% of its shares. This is not to avoid political criticism over its Iraqi assets, but also the new restrictions complicating access to the American stock market. The same is true for *GAZPROM*, the largest gas producing company in the world, *URALMASH-IZHORA* Group, one of Russia's largest integrated heavy industry companies, *URALS VIAZINFORM*, Russia's leading regional operator of telecommunications services, which decided in favour of the LSE over initial plans for an IPO in New York. There are now only six Russian, public joint-stock companies listed on the NYSE, five of which had launched IPOs before the SOX went into force.<sup>4</sup>

The SEC has released foreign companies from compliance with some of the requirements of the new legislation, but many analysts predict that this deferment will not last long. For instance, one of the provisions of the SOX - obliging the company's audit committee to be composed solely of independent directors - can be ignored by a foreign issuer only until 31 July 2005.<sup>5</sup> Total reliance on the European and Asian capital markets as a back door for Russian enterprises to avoid such restrictions is not reasonable, since the situation in the US market is just a starting point for an international tendency of adopting analogous rules. The reason for this is simple. The collapse of *Enron* and *WorldCom* was followed by similar fates for *HIH*, *OneTel* and *Harris Scarf* in Australia, and *Swissair*, *Kirch* and *Walter Bau* in Europe, while South Korea contributed *Daewoo Group* to this sorry list.

The SOX is perhaps the toughest set of regulatory requirements imposed on corporations. It therefore exposes more of the problems in Russian corporate governance that deprive Russian companies of access to foreign investor bases. The SOX enormously increases the intervention of US Federal law in corporate governance, which traditionally lay mostly within the scope of state regulation. Its adoption caused a wave of irritation, on the other side of the Atlantic, as European companies listed in the US failed to find many exceptions

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<sup>4</sup> <<http://www.nyse.com/about/listed/6.html?country=Russia>> at 19 June 2005.

<sup>5</sup> Standards relating to listed company audit committees [release nos. 33-8220; 34-47654; ic-26001; file no. s7-02-03]; <<http://www.sec.gov/rules/final/33-8220.htm>> at 19 June 2005.

to the SOX requirements. As for Russian corporations, the situation is much more severe. Having introduced provisions governing joint stock companies in the new *Civil Code* in 1994, and then in the *Joint Stock Companies (JSC) Law* in 1996, Russian legislators stopped keeping abreast of the times. Since then, both British and continental regulators have made several steps towards aligning their corporate governance standards and have introduced what is now called “best corporate practice”.

The SOX went even further and transposed rules relating to corporate governance issues from “soft” to “hard” law.

There are two overriding aspects of the problem in question. The first concerns the contradictions between the SOX and Russian laws governing public joint-stock companies which *directly* obstruct access to the US Stock Exchanges. The second aspect deals with the incompatibilities between the two law regimes which *indirectly* prevent or discourage corporations in Russia from going public and obtaining listing in the US. The problem is that Russian public joint-stock companies are used to working in more favourable conditions with respect to disclosure requirements, obligations of the corporate executive body, and liability of the company itself. Many companies are simply not ready to open their books to investors and knuckle down to stiffer disclosure requirements than they are used to in Russia. Making a decision whether to seek an IPO abroad constitutes a great dilemma for a Russian corporation because a positive decision means that all corporate standards of running business, corporate governance system and corporate policy will all have to be changed. This is a step which most companies still cannot afford to make.

The scope of this article doesn't allow me to tackle both these aspects of the problem. I will only touch upon conflicts between the SOX and the Russian *JSC Law* with respect to one particular corporate governance issue: establishing committees within the Board of Directors. Possible solutions for these contradictions will be suggested. This will, I hope, give some insight into the overall state of affairs in Russian corporate governance.

## **Nomination and Compensation Committees: combined approach?**

Russian practices still lag far behind Western recommendations of proper corporate governance standards. According to the results of a survey<sup>6</sup> conducted by the Independent Directors' Association (IDA) in 2002, only 3.7 % of the companies in Russia have permanent working committees for strategic development inside the Board of Directors. The absence of committees in other companies obviously testifies to a weak structure of the Boards of Directors or to the lack of precise differentiation of functions and duties between their members.

The youthful Russian corporate governance tradition is predominantly unaware of the fact that a Board of Directors can have its own internal structure, namely division in the committees. Establishment of committees and delegating some of the Board's powers to them is a common practice for US corporations. Committees are supposed to deal with the most sensitive issues for shareholders. Their names speak for themselves – Audit

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<sup>6</sup> *Independent Director Activities on the Board of the Russian Companies*, Survey conducted by Independent Directors Association in collaboration with Investor Protection Association and Ernst & Young CIS Limited, March 2002; <[http://www.corp-gov.ru/upload/file/\(1\)General\\_Survey\\_eng.doc](http://www.corp-gov.ru/upload/file/(1)General_Survey_eng.doc)> at 19 June 2005.

Committee, Remuneration Committee, Nominating Committee, Strategy Committee, Ethics Committee. The list is not exhaustive - only the most common committees are mentioned above and the companies are allowed to establish any other ones. The Audit Committee has gained the status of "compulsory",<sup>7</sup> where the Compensation and Nominating committees are governed by "comply-or-explain" regimes,<sup>8</sup> meaning that their establishment within the Board of Directors is strongly recommended.

Establishment of the two latter committees doesn't seem to constitute a problem for a Russian company deciding to go public in the US. The Russian Federal Commission on Securities Market (FCSM) has adopted a Code of Corporate Conduct,<sup>9</sup> however, it doesn't bind the companies and comprises only recommendations for the improvement of corporate governance. Section 4.10 of the Code proposes joining the Nomination and the Compensation Committees. The name for the united committee under the Code of Corporate Conduct is the *Human Resources and Remuneration Committee*. The combined approach, which is possible, in the author's view, would however, only create unnecessary obstacles for Russian companies in SEC registration procedures and further compliance with its provisions on disclosure. According to the US Federal Law and Stock Exchanges' rules, the Nominating committee and the Compensation Committee are treated differently. The Nominating Committee is not only subject to special rules on disclosure, but also subject to additional requirements with respect to its composition. The recent string of corporate scandals has reawakened the SEC's interest in the director nomination process. New SEC Rules require expanded Nominating Committee disclosure in proxy statements in November 2003.

The new SEC rules harmonize with the NYSE and Nasdaq Stock Market listing standards.<sup>10</sup> They require companies to include in their proxy statements significant additional disclosure regarding the nominating committee, the process for nominating directors, and the mechanics for shareholder communications with directors.<sup>11</sup>

Companies seeking access to the US capital market are well advised to avoid the recommendations of the Commission on Securities Market and establish two separate committees, in order to ensure compliance with the Federal Securities Law and America's best corporate practices.

In all other respects, Russian companies should not experience any serious difficulties while establishing the Nomination and the Compensation Committees, except for their membership. Federal law, in conjunction with the NYSE, requires the members of the committees to be independent directors, and the criteria for directors being deemed "independent" has not been developed in Russian legislation.

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<sup>7</sup> Section 10A(m)(1) of the *Securities Exchange Act* of 1934, as amended, as added by s 301 of the *Sarbanes-Oxley Act* of 2002.

<sup>8</sup> See, eg, SEC Rules Requiring Expanded Nominating Committee Disclosure in Proxy Statements; <[www.sec.gov/rules/final/33-8340.htm](http://www.sec.gov/rules/final/33-8340.htm)> at 27 May 2005.

<sup>9</sup> English version of *Russian Code of Corporate Conduct* is available at <<http://www.usrbc.org>>

<sup>10</sup> NYSE Listed Company Manual s 303A.04 and NASD Rule 43 50(c).

<sup>11</sup> <[www.sec.gov/rules/final/33-8340.htm](http://www.sec.gov/rules/final/33-8340.htm)> at 27 May 2005.

## Audit Committee v Inspection Commission

The situation concerning the Audit Committee tends to be more complicated. The Audit Committee is traditionally a key-element of the corporate governance structure in US public companies. It is considered to be the conscience of the corporation, conferred with certain powers. The SOX introduced a new era in its evolution, having appointed the Audit Committee as a principal player in the effort to implement reform and rebuild public trust.

Russian corporate law does not require an Audit Committee. However, all Russian open, joint-stock companies are required to establish and maintain an Inspection Commission.<sup>12</sup> This body might be equated with the Audit Committee, but with many reservations. It is assumed that the Russian legislators intended to create the Inspection Commission as an analogy of the Audit Committee. Nonetheless, they opted for their own approach, making it different from common practice. Nobody knew at that time that, in the beginning of the 21<sup>st</sup> century, it would create obstacles for Russian companies seeking listing abroad. What are the differences between these entities?

The SOX defines the Audit Committee as being "established by and amongst the board of directors of an issuer".<sup>13</sup> The provision of the Russian *JSC Law*, to the contrary, deters the members of the Inspection Commission from serving on the Board of Directors,<sup>14</sup> emphasizing that they cannot simultaneously hold positions in any of the company's governing bodies. Moreover, under the *JSC Law*, the members of the Inspection Commission are elected by the shareholders' general meeting,<sup>15</sup> whereas the SOX names the Board of Directors, which is responsible for the appointment of the Audit Committee members.<sup>16</sup>

According to the US listing standards, the minimum number of directors serving on the Audit Committee cannot be less than three. Moreover, the SOX imposes additional requirements, namely, that at least one member should be financially literate.<sup>17</sup> To the contrary, the *JSC Law* allows a company to appoint a single internal auditor instead of the Inspection Commission and doesn't require him to have knowledge in the relevant area.

The *JSC Law* confers the Inspection Commission with certain powers and duties.<sup>18</sup> Among other things, the Inspection Commission is empowered to initiate a review or audit of the company's finances at least once a year, prepare a report on the state of the issuer's financial documents, and verify the accuracy of the data included in the issuer's annual report and financial statements. Unlike *JSC Law*, the SOX puts special emphasis on the functions of the Audit Committee with respect to the company's relations with an external auditor. Thus, the Audit Committee of each issuer is "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting company employed by that issuer (including resolution of disagreements between

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<sup>12</sup> See Article 85-1 of the *JSC Law*.

<sup>13</sup> Section 205 of the SOX.

<sup>14</sup> Article 85-6 of the *JSC Law*.

<sup>15</sup> Article 85-1 of the *JSC Law*.

<sup>16</sup> Section 301 of the SOX.

<sup>17</sup> Section 407 of the SOX.

<sup>18</sup> Articles 85, 87 and 88 of the *JSC Law*.

management and the auditor regarding financial reporting.”<sup>19</sup> As for the appointment of the audit company, foreign issuers were exempted by the SEC from compliance with this requirement. Determination of the compensation to be paid to an external auditor is the responsibility of the Board of Directors under the *JSC Law*.<sup>20</sup> This seems to create another conflict of laws, if the Inspection Commission is treated as an equivalent of Audit Committee.

So the legal status and competence of the Audit Committee and the Inspection Commission are far from identical. Should Russian issuers create a dual, audit body structure in the company, or should they extend the authority of the Inspection Commission to comply with the SOX? Establishment of an Audit Committee in addition to an Inspection Commission, with duplicate functions, might not only be costly and inefficient, but could also generate possible conflicts of powers and duties. On the other hand, the Inspection Commission is no equivalent of the Audit Committee. The situation is ripe for deadlock. The company seeking to list in the US stock market ought to opt for a dual, internal control system, in spite of all its disadvantages. Most of the Russian public, joint stock companies already oriented on overseas markets have already created an Audit Committee in their Boards of Directors. The Russian Code on Corporate Conduct also encourages companies to opt for a dual, internal audit structure.<sup>21</sup> Also, a corporate governance structure encompassing an Audit Committee is more attractive for foreign investors and the corporation’s business partners. Thus, there is direct evidence of a gap in Russian company law. Elimination of this gap should be a priority for the Parliament, as it enormously restricts Russian business from integration into world trade.

The clashes of the SOX with Russian *JSC Law* on aspects of corporate governance structure and the proposed directions for conformance of Russian corporate governance rules to international standards are not exhaustively listed here. This article focuses on but a few imperfections deterring Russian companies from accessing US capital markets. This is the tip of a substantial iceberg. This topic warrants more research. The process of reorganization in Russian companies and their integration into the world economy has just begun.

[Edited by Melissa Hofmann]

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<sup>19</sup> Section 301 of the SOX.

<sup>20</sup> Article 86-2 of the *JSC Law*.

<sup>21</sup> See Section 4.9 Chapter 3 of Russian Code of Corporate Conduct (English version is available at <<http://www.usrbc.org>>).

Sarbanes-Oxley Act of 2002. Corporate responsibility. 15 USC 7201 note. (6) enforce compliance with this Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, by registered public accounting firms and associated persons thereof; and. (7) set the budget and manage the operations of the Board and the staff of the Board. (d) COMMISSION DETERMINATION. The members of the Board shall take such action (including hiring of staff, proposal of rules, and adoption of initial and transitional auditing and other professional Download Citation | Compliance with the Sarbanes-Oxley Act of 2002: challenge for Russian Corporate Governance | [Extract] The transitional period from socialism to capitalism in Russia gave birth to business enterprises with different organisational forms. | Find, read and cite all the research you need on ResearchGate. In 1999, the Studies on Russian Economic Development published an article by T. Speranskaya who compares the Russian model of banking with the Chinese one [1]. The author looks at government banking and the relevance of banks for the non-financial economy and concludes that banking models in China and Russia are different. The Sarbanes-Oxley Act of 2002 is mandatory. ALL organizations, large and small, MUST comply. This website is intended to assist and guide. It provides information, and identifies resources, to help ensure successful audit, and management. Whether you are entirely new to the Sarbanes-Oxley legislation, or whether you have an established strategy, this portal should hopefully prove to be of substantial value. Introduction The legislation came into force in 2002 and introduced major changes to the regulation of financial practice and corporate governance. Named after Senator Paul Sarbanes and Re ==TITLE II" AUDITOR INDEPENDENCE==. (a) PROHIBITED ACTIVITIES". Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1) is amended by adding at the end the following: "(g) PROHIBITED ACTIVITIES" Except as provided in subsection (h), it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title or the rules of the Commission under The Sarbanes-Oxley Act of 2002 (Pub.L. 107-204 (text) (pdf), 116 Stat. 745, enacted July 30, 2002), also known as the "Public Company Accounting Reform and Investor Protection Act" (in the Senate) and "Corporate and Auditing Accountability, Responsibility, and Transparency Act" (in the House) and more commonly called Sarbanes-Oxley or SOX, is a United States federal law that set new or expanded requirements for all U.S. public company boards, management and public accounting firms. A number of