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HARNESSING THE POWER OF STEWARDSHIP FOR RUSSIAN CAPITAL MARKETS

UK-Russia Corporate Governance Working Group Report

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MIFC aims to establish a high-tech, world-class competitive financial market in Russia, create more opportunities for individuals to take part in finance.

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Forum Analytical Centre has served as financial markets development RnD hub since 2010. AC Forum is an integration platform designed to bring together all interested parties: the Bank of Russia as megaregulator, other ministries, licensed market participants and their associations, and the international investment community.

API

API is Russia's leading association of institutional investors, uniting over 25 of the largest and most active funds with over $30 billion in portfolio investments in Russia. API's members, who include APG AM, UCP Investment Group, East Capital, Genesis IM, Prosperity CM, Sberbank AM, VTB Capital AM many others, are united under its banner to form a coalition to protect their interests and advance the cause of better corporate governance in Russia.

Through API's efforts over the past 15 years, over 450 independent directors have been elected to the boards of over 160 Russian public companies, including Sberbank, M.Video, RAO UES, Dixi, IDGC (aka "MRSK") Holding, Cherkizovo, Rostelecom and many others. There are now over 30 independent directors serving at 25 companies, as a result of consolidation by API members and other investors.

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FOREWORD

Global capital markets are being increasingly influenced by investors placing greater emphasis on their stewardship responsibilities, particularly in relation to environmental, social and governance responsibilities. As a consequence, there is an increasing desire by both investors and companies to engage responsibly about these and other issues in order to ensure there is a mutual understanding of not only objectives but also of values and culture. The power of stewardship to align interests throughout the investment chain has never been stronger.

The UK continues to play a leading role in developing best practice in respect of corporate governance, investor stewardship and responsible shareholder engagement.

This report aims to compile best practices in responsible investment for the benefit of the Russian business community. We hope that all parties will take these ideas on board and build their own approach and action plan.

As stated in the report, responsible investment principles are no longer an optional extra in global capital markets practice – they form an integral part of each party's day-to-day activities. We welcome this report and its recommendations in the hope that Russian capital markets will integrate best practice in governance and stewardship, and thereby unlock their potential to provide long-term prosperity for all.

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EXECUTIVE SUMMARY

Investor stewardship, often underpinned by a stewardship code, is no longer an optional extra in many leading global capital markets. Asset owners and asset managers are expected to engage responsibly with the companies in which they invest and be accountable to the ultimate beneficiaries of the investment chain for how they have fulfilled their stewardship responsibilities. Also, they are increasingly incorporating environmental social and governance (ESG) factors into their investment processes.

The UK is a leader in the field of investor stewardship and responsible shareholder engagement, having published the world's first stewardship code in 2010. The current UK Stewardship Code has 280 signatories. Its implementation and enforcement are overseen by the Financial Reporting Council (FRC), which is currently leading a consultation to significantly strengthen the Code and broaden its scope.

Currently, there is no Russian Stewardship Code and the principles of ESG investment are not generally integrated into Russian investment processes. Also, responsible shareholder engagement about ESG factors is neither very common nor are there generally accepted approaches to such engagement by investors in the listed securities of Russian issuers.

Therefore, this report recommends that a steering group and a working group, both led by the Bank of Russia and the Association of Institutional Investors ('API') be set up to oversee the steps necessary to enable a credible and progressive approach to investor stewardship in Russian capital markets. This will include the development, implementation and enforcement of a Russian Stewardship Code and related Responsible Shareholder Engagement Guidelines. Because the code and guidelines would, in practice, operate in tandem with the Russian Corporate Governance Code, consideration should be given to bringing the latter within the scope of the investor stewardship steering and working groups.

Furthermore, it is recommended that the Bank of Russia, as part of its on going initiative to make Russia's capital markets more robust and attractive to both foreign and domestic companies and investors, should sponsor an on going series of roundtables or conferences – one or two a year – to explore ways to improve investor stewardship and engagement in Russia.

Having summarised some of the distinctive features of Russia's capital markets, the report makes recommendations that provide a pathway for Russian capital markets to embrace the spirit of investor stewardship in a considered and purposeful way.

WHAT IS A STEWARDSHIP CODE?

A stewardship code provides principles-based guidance to assist institutional investors – both asset owners and asset managers – to fulfil their responsibilities as stewards of the assets entrusted to them by their clients and beneficiaries. The principles are generally applied on a 'comply or explain' basis, whereby signatories to a code are required to confirm that they have complied with its principles or, if not, to explain why. Such disclosures are generally made on the signatories' websites. Principles are preferred to rules because there are so many different situations to which stewardship applies and it gives the signatories to the code an opportunity to bring their own approaches and preferences to bear.

The main purpose of a stewardship code is to align the interests of all the constituents in the investment chain (figure 1) so that they all behave in a manner that is consistent with the interests, financial and non-financial, of the ultimate beneficiaries. A stewardship code also provides a framework of accountability that enables the constituents in the stewardship chain to hold asset owners and asset managers, as appropriate, to account for how they have complied with the code's principles and provisions.

Figure 1: The investment chain

Stewardship codes also serve several other important purposes, including:

- Providing appropriate regulators with a basis for holding institutional investors to account for how they fulfil their stewardship responsibilities.
- Providing a point of accountability reference for other stakeholders who have a legitimate interest in the behaviour of institutional investors.
- Complementing corporate governance codes by providing a facilitating framework for responsible engagement by institutional investors with the boards and management of companies, with a view to ensuring that there is a mutual understanding of objectives and, increasingly, other attributes, such as values.

The first stewardship code, the UK Stewardship Code, was launched by the FRC in 2010. It currently has 280 signatories including some of the world's largest and most influential institutional asset managers, such as BlackRock, Vanguard, Legal & General and most of the UK's largest pension funds, as well as several from overseas. This level of support is critical because it adds credibility and clout to the code – without it, the code would be unable to fulfil its purposes effectively.

Globally there are 32 stewardship codes[1] and others are under development[1]. Most stewardship codes are usually maintained and promoted by relevant regulators or recognised investor bodies, such as Eumedion, a Dutch foundation which represents institutional investors' interests in the field of corporate governance and is responsible for the Dutch Stewardship Code.[2]

[1] Minerva Analytics, Global corporate governance codes webpage, (as of August 2018), available at: https://www.manifest.co.uk/portfolio/global-governance-codes/

[2] The Dutch Stewardship Code, available at: https://www.eumedion.nl/en/public/knowledgenetwork/best-practices/2018-07-dutch-stewardship-code-final-version.pdf

What do stewardship codes address?

No two stewardship codes are exactly the same, because they are all tailored to local custom and practice, as well as local legislation and regulation. However, most stewardship codes address the following aspects of responsible investment.

Conflicts of interest

Most asset owners and asset managers have conflicts of interest to manage when it comes to fulfilling their stewardship responsibilities. For example, a conflict will arise if one of the asset owner's trustees or one of the investment manager's directors sits on the board of a company in which the asset owner or the asset manager has an investment. As a matter of fiduciary responsibility, it is vital that the asset owner and the asset manager act in the best interest of their beneficiaries, such as pensioners, or their clients. As appropriate, stewardship codes require such conflicts to be identified and disclosures made about how they are managed.

Engagement with investee companies

As a matter of principle, stewardship codes generally require their signatories to engage responsibly with the boards and management of the companies in which they invest. As a practical matter, the signatories cannot usually engage with the boards and management of all the companies in which they invest. Large investment managers invest in thousands of companies all around the globe and they do not have the resources to engage with them all. However, they are expected to have an engagement policy setting out the criteria they use for deciding when to engage, for example, engaging annually the boards of companies in which they have a significant investment; whereas others may have policy of engaging only when significant issues arise. Stewardship codes generally require such policies to be disclosed in appropriate degrees of detail. Many asset owners delegate engagement to their asset managers and disclose this – usually naming the asset managers concerned and providing a link to their asset manager's website in order to fulfil their stewardship code responsibilities.

Engagement escalation

Responsible shareholder engagement for many institutional investors goes beyond merely voting the shares which are owned or managed by the signatory at Annual General Meetings (AGM) and at the class meetings of other securities. It is not uncommon for the boards and management of investee companies to ignore the views of individual asset owners and asset managers, often claiming but they are the only people to have raised an issue and when often that is not the case. Some stewardship codes set out guidelines about how signatories should escalate their engagement and often encourage them to cooperate and collaborate with other asset owners and asset managers, as and when appropriate. It is more likely the boards and management will listen to the views of several asset owners and managers, who share the same view. Indeed, in the UK, the Investor Forum was set up to help coordinate the views of like-minded investors when issues arise and, if instructed, to engage with boards and management on their collective behalf. In addition, stewardship codes will often set out guidelines about the stages of escalation that should be followed when their views are being ignored. These include actions like writing a formal letter to the board about the issue concerned and, when most other steps have been exhausted, attending AGMs and making a statement and asking a question related to the issue.

Voting disclosure

Stewardship codes address voting policies used by asset owners and asset managers and the disclosure of votes cast. As a matter of principle, they require code signatories to have well thought through cohesive voting policies, which are often approved by the governing body of the asset owner or the asset manager to give them an added authority. To provide accountability through transparency, stewardship codes generally require efficient disclosure of voting outcomes, which thereby enables clients, customers and others to determine how asset owners and asset managers voted on specific resolutions.

The advantages and disadvantages of stewardship codes

Since their inception, there has been debate as to whether stewardship codes, in general, are advantageous or disadvantageous. It is fair to presume that global institutional investors – both asset owners and asset managers – believe that stewardship codes are advantageous by virtue of their willingness to voluntarily become code signatories and their public commitment to the principles that the codes seek to uphold. Likewise, many regulators who have a corporate governance codes have supported the introduction of a stewardship code for their markets because of the advantages that accrue to market confidence through effective investor stewardship. Issuers have also been generally supportive because they have often experienced improved engagement with their investors about corporate governance matters.

Some of the key advantages and disadvantages of stewardship codes are set out in the following tables.

Key advantages of stewardship codes

In respect of investor responsibility for ESG, stewardship codes achieve or provide:

- Alignment of interests throughout the investment chain. This helps to ensure that the best interests of the ultimate beneficiaries are respected in decision-making throughout the investment chain.
- Accountability throughout the investment chain. Increasingly asset managers and asset owners are publishing regular detailed reviews on their stewardship activities to help fulfil their code responsibilities.
- Disclosure of how asset managers and asset managers manage conflicts of interest. A stewardship code forces its signatories to give careful thought to the identification of conflicts and how they are addressed in a transparent way.
- Transparency of voting by asset managers and asset owners. Although voting is just one stewardship tool, it is a very important one and when asset managers and asset managers vote against a relation recommended by a company's board, it is vital that they explain to both the company's board and their clients and beneficiaries why they have done so.
- A basis for enabling effective engagement by asset managers and asset managers, individually or collectively, with the boards and management of investee companies, especially when ESG issues and concerns arise. Such engagement lies at the heart of responsible investor stewardship and a stewardship code provides useful guidance as to what is required and expected.

Key disadvantages of stewardship codes

- Box ticking and boilerplate reporting by some code signatories. Regulators need to ensure they allocate appropriate resources to evaluate effectively how code signatories fulfil their stewardship responsibilities.
- They can be challenging for regulators to enforce effectively. For example, it can be difficult to check the accuracy of information that is disclosed.
- In some cases, codes can set unrealistic expectations of the stewardship capabilities of code signatories to engage with their investee companies, especially when their portfolio has a large number of investee companies listed in geographically diverse markets.
- They tend to focus on responsibilities relating to equity securities issued by listed companies, whereas many of the codes' principles are applicable to non-equity instruments issued by listed companies, such as loan stock, and to alternative investments, such as property and private equity.
- Too much emphasis tends to be given to requiring disclosure by code signatories of their stewardship policies, rather than to the stewardship outcomes when the policies are put into practice.

THE GROWING IMPORTANCE OF STEWARDSHIP CODES AND RESPONSIBLE INVESTMENT

ESG considerations and sustainable investing have moved into the mainstream of institutional investment and ESG criteria are becoming increasingly part of investment mandates given by asset owners to asset managers. Such criteria can cover a wide range of issues, such as the adequacy of disclosure on carbon emissions, executive pay, both quantum of pay and the nature of performance conditions used for incentive pay schemes, the approach to human rights in a company's supply chain, and boardroom diversity. See the table below for more information about responsible investment and ESG criteria.

There are no reliable estimates of the aggregate amount invested globally using ESG criteria but Larry Fink, in an interview with the Financial Times in October 2018, estimated that assets in electronically traded funds that incorporate ESG factors will grow from US$25bn to more than US$400bn in a decade.[3] In any event, it is fair to say that ESG factors are now moving capital in a way that has never been seen before. Therefore, it is beneficial that boards and shareholders engage responsibly about these matters to help reduce the company's cost of capital and ensure that the interests of the shareholders are being taken into consideration by the company's board. It should be a win-win situation.

What is responsible investment?

Responsible investment is an approach to investing that aims to incorporate ESG factors into investment decisions, to better manage risk and generate sustainable, long-term returns.[4]

Responsible investment has been practiced by many investors for many years. However, over the last three years it has gathered a revolutionary momentum driven by a range of factors including:

- Increased recognition in the financial community that ESG factors play a material role in determining risk and return and are part of investors' fiduciary duty to their clients and beneficiaries.
- Concern about the impact of short-termism on company performance, investment returns and market behavior.
- Pressure from competitors seeking to differentiate themselves by offering responsible investment services as a competitive advantage.
- Beneficiaries becoming increasingly active and demanding transparency about where and how their money is being invested.
- Value destroying reputational risk from issues such as climate change, pollution, working conditions, employee diversity, corruption and aggressive tax strategies in a world of globalisation and social media.

[3] BlackRock stakes claim on 'sustainable investing' revolution, Financial Times, October 23, 2018, available at: https://www.ft.com/content/f66b2a9e-d53d-11e8-a854-33d6f82e62f8

[4] Sourced from the 'Principles of Responsible Investment', which is an investor initiative in partnership with UNEP Finance Initiative and UN Global Compact, available at: https://www.unpri.org

Examples of ESG factors

Examples of ESG factors are numerous and ever shifting. They include:

Environmental

- climate change – including physical risk and transition risk
- resource depletion, including water
- waste and pollution
- deforestation.

Social

- working conditions, including slavery and child labour
- local communities, including indigenous communities conflict
- health and safety
- employee relations and diversity.

Governance

- executive pay
- bribery and corruption
- board diversity and structure
- tax strategy.

The global investment community strongly supports the principles of stewardship and increasingly look to capital market regulators to provide a robust framework – generally through stewardship codes – to enable them to put the principles of stewardship into practice. Indeed, to enable them to fulfil their ESG responsibilities, many larger institutional investors have dedicated ESG teams, who typically have responsibility for voting their clients' shares, engaging responsibly with their investee companies about ESG matters and reporting on their websites and to their clients about the activities they have undertaken on their behalf.

Stewardship codes have primarily focused on equity investors, but increasingly global investors, such as Aberdeen Standard, are applying the principles of stewardship codes to other investment classes and the FRC is proposing to reflect this shift in its 2019 UK Stewardship Code.

The UK Stewardship Code

In response to the financial crisis in 2009, the then UK Prime Minister commissioned Sir David Walker to examine board practices at UK banks and other financial institutions. One of the key themes of his report was that active engagement with boards of directors remains a responsibility of shareholders and he recommended the development of a stewardship code to which institutional investors could subscribe.

In 2010 the FRC published the world's first stewardship code with the aim of promoting the long-term success of companies in such a way that the ultimate providers of capital also prosper. It closely mirrored a Statement of Principles regarding the responsibilities of institutional shareholders that was first published by the well-respected Institutional Shareholders Committee.

The FRC published the second edition of the UK Stewardship Code in 2012, which remains in force but, as discussed later in this report, the FRC is currently consulting on some significant changes. It pinpointed in the code the primary responsibility for stewardship rests with the board of a company, but recognised that investors play an important role in holding the board to account for its responsibilities. The 2012 UK Stewardship Code is directed at institutional investors – both asset owners and asset managers. It is not a rigid set of rules; rather, it comprises seven 'comply or explain' principles (see 'the principles of the 2012 UK Stewardship Code' box), with supplementary guidance, that set out the stewardship responsibilities of institutional investors. In the preamble to the UK Stewardship Code, the FRC emphasises that stewardship is more than just voting. It includes monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration. The UK Stewardship Code has therefore been considered for review biennially by the FRC. It now has 280 institutional investors as signatories.

The principles of the 2012 UK Stewardship Code

So as to protect and enhance the value that accrues to the ultimate beneficiary, institutional investors should:

- Publicly disclose their policy on how they will discharge their stewardship responsibilities. The code explains that stewardship activities include monitoring and engaging with companies on matters that include strategy, risk, performance and corporate governance. The code emphasises that the policy should disclose how application of stewardship enhances and protects value for the ultimate beneficiary or client.
- Have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed. The code indicates that institutional investors should have and publicly disclose a policy for identifying and managing conflicts of interest. It goes on to state that the aim of the policy should be the taking 'all reasonable steps' to put the interest of the client or beneficiary first.
- Monitor their investee companies. The code states that 'effective monitoring is an essential component of stewardship'. Institutional investors are urged to undertake a number of activities including keeping abreast of corporate performance, satisfying themselves that the company's leadership is effective and considering the quality of the company's reporting.
- Establish clear guidelines on when and how they will escalate their stewardship activities. The code suggests that these guidelines should cover the circumstances in which the institutional investor will actively intervene. It states that initial discussions should take place on a confidential basis but if a company does not respond constructively then institutional investors should consider whether to escalate their action. For example, by meeting the chairman or other board members, or speaking at AGMs and other shareholder meetings.
- Be willing to act collectively with other investors where appropriate. Collective engagement is considered to be most appropriate at times of significant stress, or where the risks posed threaten to destroy significant value. Under the code's provisions, institutional investors should disclose their policy on collective engagement, including the kind of circumstances in which the institutional investor would consider acting collectively.
- Have a clear policy on voting and disclosure of voting activity. The code makes clear that institutional investors should seek to vote all shares held and should not automatically support the board. They code provides that they should disclose publicly their voting records, whether they use proxy voting advisory services and their approach to stock lending.
- Report periodically on their stewardship and voting activities. The code stipulates that asset managers should account regularly to their clients or beneficiaries how they have discharged their responsibilities. An increasing number of leading UK institutional investors publish annual reviews of their stewardship activities, which are available on their websites.

The UK Stewardship Code has led to improvements and quality of engagement between investors and companies. That said, in January 2016 the FRC, while acknowledging that 'a culture of stewardship will take time', indicated that 'action is needed to ensure appropriate momentum is maintained in implementing the stewardship code', because of concerns that the reporting of a number of signatories demonstrates that they are not following through on their commitment to the stewardship code.[5]

Accordingly, in November 2016, the FRC took steps 'to improve the quality of reporting against the code, encourage greater transparency in the market and maintain the credibility of the code', and assessed the signatories based on the quality of their code statements and placed them in three tiers as described in the below.[6]

UK Stewardship Code tiering categories

Signatories to the code have been tiered according to the quality of the reporting in their statements based on the seven principles of the code and the supporting guidance. Asset managers have been categorised in three tiers and other signatories in two tiers.

Tier 1

Signatories provide a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary.

Tier 2

Signatories meet many of the reporting expectations, but report less transparently on their approach to stewardship or do not provide explanations where they depart from provisions of the code.

Tier 3

Significant reporting improvements need to be made to ensure the approach is more transparent. Signatories have not engaged with the process of improving their statements and their statements continue to be generic and provide no, or poor, explanations where they depart from provisions of the code.[7]

Those institutional investors who were assigned to Tier 3 and did not make sufficient improvements to their reporting were removed as signatories to the Code in August 2017.[8] As a consequence, all signatories to the Code are in Tier 1 or Tier 2 and they are listed on the FRC's website.[9]

[5] Financial Reporting Council, "Developments in Corporate Governance and Stewardship 2015", (January 2016)
[6] FRC website, available at: https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements
[7] Tiering of Signatories to the Stewardship Code, available at: https://www.frc.org.uk/news/november-2016/tiering-of-signatories-to-the-stewardship-code
[8] Some tier 3 signatories removed themselves voluntarily from the UK Stewardship Code prior to August 2017.
[9] Tiering of Stewardship Code Signatories, available at: https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements

The 2019 UK Stewardship Code – consultation proposals

In December 2018 the FRC published some high-level consultation questions about the UK Stewardship Code, which marked the beginning of a review of the Code. The decision to update the Code was based a number of factors. The UK has been experiencing an ongoing a shift in views relating to the role of business in society and a growing awareness of the importance of its responsibilities to stakeholders. This shift in views gained momentum following several high-profile corporate failures, which served to increase the importance attached to ESG investment. In addition, a review of the FRC by Sir John Kingman expressed serious concerns about the overall effectiveness of the stewardship code.[10]

Against this background, the FRC published on 30 January 2019 for consultation its proposals for the 2019 UK Stewardship Code.[11] The main proposed changes to the existing Code include:

- **Purpose, values and culture:** investors must report how their purpose, values and culture enable them to meet their obligations to clients and beneficiaries. This aligns the proposed Code with the UK Corporate Governance Code, and also should help to ensure effective stewardship behaviours are embedded in the investor community.
- **Recognising the importance of ESG factors:** the proposed Code refers specifically to ESG factors. Signatories are expected to consider material ESG issues when fulfilling their stewardship responsibilities.
- **Stewardship beyond listed equity assets:** the proposed Code now expects investors to exercise stewardship responsibilities across a wider range of assets, such as loan stock and private equity, where they have influence and rights, in the UK and globally.

In addition, there are a number of proposed changes to address concerns that the current Code focuses too much on the stewardship policies of asset managers and not the outcomes achieved from those policies. Also, there are concerns that there are too many signatories in Tier 1 who are not necessarily as effective as they could be.

Finally, a subtle but significant tweak is proposed to the 'comply or explain' approach that has been used to date. Under the proposed 2019 UK Stewardship Code the principles are to be followed on 'apply and explain' basis which means that signatories will no longer be able pick and choose which principles to comply with – rather they will have to apply them all and make a clear statement to explain how they have done so. This is a much more robust approach than is currently the case. The proposed Code's provisions, which support its principles, are to be followed on a 'comply or explain' approach. If signatories choose not to comply with a provision they should explain why and disclose what alternative approach they have taken.

Although it remains to be seen which of the FRC's consultation proposals will be reflected in the final version of the 2019 UK Stewardship Code, the direction of travel is clear – the new Code will result in a more robust and broader stewardship environment than is currently the case. This should serve to strengthen confidence in the UK's capital markets, and the role and accountability of companies and institutional investors.

[10] The Kingman Review Report refers to the Independent Review of the Financial Reporting Council, which was led by Sir John Kingman and reported in December 2018, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

[11] Financial Reporting Council, available at: https://www.frc.org.uk/news/january-2019-(1)/frc-strengthens-stewardship-code

EFFECTIVE INVESTOR STEWARDSHIP IN RUSSIA

The context, the challenges and the opportunities

The Moscow Exchange's Equity and Bond Market is Russia's largest and the Moscow Exchange is among the top 30 leading stock exchanges worldwide.[12]

The Moscow Exchange's equity indices comprise 42 stocks, with the three largest stocks accounting for 42.5% of the index capitalisation, the five largest stocks accounting for 54.1% and the ten largest stocks accounting for 72.2%.[13]

Figure 1: Top 10 companies by market cap on the Moscow Exchange Indices

Source: Moscow Exchange, February 2019

SBER / Sberbank
ROSN / Rosneft
LKOH / Lukoil
GAZP / Gazprom
NVTK / Novatek
GMKN / Norilsk Nickel
TATN / Tatneft
SNGS / Surgetneftegas
NLMK / NLMK
CHMF / Severstal

By contrast, the Moscow Exchange's Corporate Bond Index comprises 100 constituents and is broadly based with the largest constituent representing only 2.5% of the index.[14] It is relevant to note that many Russian asset managers are, in practice, unable to invest in Russian equities because of stress test compliance factors. Also, with corporate bonds, they are in competition with federal bonds.

Many issuers are majority owned, directly or indirectly, by the Russian Federation. For example, as of 31 December, 2017 the cumulative shareholding held directly or indirectly by the Russian Federation in Gazprom was 50.23%.[15] The level of free-float shares held, directly and indirectly, by foreign investors in Russian companies tends to be significant – often more than 70% – and their exposure is often held in ADRs listed on foreign stock exchanges. As a consequence, domestic investors can struggle to exercise influence on Russian listed companies and on the Russian market, more generally. The issuers, therefore, tend to focus their investor relations efforts on foreign institutional investors but the risk appetite of the latter in respect their exposure to Russian securities has, for now, been largely satisfied. Consequently, Russian listed companies seeking fresh capital and an active market in their shares need to identify new foreign investors, which is no easy task in the current geopolitical climate and the increased importance that many of them are now placing on high standards of ESG before investing.

In addition, a high proportion of issuers with securities listed on the Moscow Exchange are engaged in energy and extractive industries, which tend to have important but sensitive ESG risk factors as well as being capital intensive.

[12] Moscow Exchange website, available at: https://www.moex.com/s338
[13] As at January 24, 2019. Source: Moscow Exchange website, available at: https://www.moex.com/en/index/RTSI/constituents/
[14] As at January 24, 2019. Source: Moscow Exchange website, available at: https://www.moex.com/en/index/RUCBITR/constituents/
[15] Gazprom 2017 Annual Report http://www.gazprom.com/f/posts/60/709300/gazprom-annual-report-2017-eng.pdf

As a consequence of the concentrated ownership of Russian companies, it can be difficult for minority shareholders to engage influentially with the boards of listed companies on the Moscow Exchange. That said, Russia's cumulative voting system allows minority investors – and, in particular the foreign ones because of their significant holdings – to influence Board composition at Russian listed companies. The cumulative voting provides that every shareholder's votes are multiplied by the number of Board seats. The resulting number of cumulative votes may be cast for one or more candidates. The first candidates among those receiving the most cumulative votes become Board members to the extent of the Board size. However, it is questionable whether the cumulative voting system is well understood by foreign institutional investors, some of whom may be concerned about forming unintentionally a concert party with other investors, which would not be the case when similar situations arise in the UK. Taken as a whole, the current situation provides an opportunity to promote awareness and a better understanding of the cumulative voting system, and thereby contribute to not only improvements in responsible shareholder engagement with them and the awareness of ESG risk factors by Russian listed companies, but also the perceived relative attractiveness of Russia's listed capital markets.

With the growing importance of ESG factors in investment decision making, despite the significant corporate governance improvements at many listed companies and irrespective of whether there is a Russian Stewardship Code, that more and more foreign investors will choose not to invest in Russian companies thereby increasing the latter's cost of capital. Going forward, it is vital that all Russian listed companies demonstrate that they have a convincing understanding of the environmental and social risks – as well as the governance ones – that the institutional investment community are now focussed on.

Russia's domestic institutional investors together with a number of significant major foreign investors, such as APG and Franklin Resources, are members of the API, Russia's leading association of institutional investors, which whose members 'are over 25 of the largest and most active funds with over $30bn in portfolio investments in Russia.'[16] The API serves to protect 'their interests and advance the cause of better corporate governance in Russia'.[17] In doing so, the API facilitates governance, operational efficiency at companies in which API members hold shares, and works to create transparency and improve the investment appeal of Russian companies.[18]

By way of example, with the API's support, investors annually nominate and elect about 30-40 independent directors to the boards of 20-25 companies, including Aeroflot, ALROSA, Moscow Exchange, and Magnit. The shareholders leverage the API's opportunities to unite their votes, opinions, resources in their engagement with companies, the regulator and the majority shareholder's representatives.

Also, as noted above, domestic Russian institutional investors have limited influence on Russian companies as they do not hold significant equity stakes and large blocks of corporate bonds in them. Out of the total amount (RUB 3.7 trillion) of mandatory savings and reserves (non-state pension funds, NPFs), RUB 2.5 trillion are invested in bonds, a mere RUB 370 billion (10% of the total amount) in equities, the rest in deposits and other assets. The total Russian equity market capitalisation is estimated at RUB 35.9 trillion. New allocations to NPFs remained under moratorium until 2019, which restricted growth potential and left room for organic growth only.

However, individual investment business has seen explosive growth. The number of individual investment accounts opened with Moscow Exchange reached 502,000 as of 20 November 2018, against 302,000 at the close of 2017, 195,200 at the end of 2016 and 88,900 at year-end 2015.

[16] Association of Institutional Investors website, available at: http://api-russia.org
[17] Ibid
[18] Ibid

Currently, there is no Russian Stewardship Code or guidelines for responsible shareholder engagement to facilitate such engagement in respect of Russian companies. Although it is likely that such a code or generally accepted guidelines would be welcomed by the global investment community, it would need to be convinced that they would operate effectively, with the committed support of regulation and such other measures as are necessary to establish the foundations for a strong and effective stewardship and responsible shareholder engagement environment in Russia. To enable this, it would be essential that the API and its leading members and the largest Russian listed companies not only acknowledge the benefits of investor stewardship and responsible shareholder engagement, but also demonstrate by their actions their commitment by fulfilling their stewardship and engagement responsibilities, as appropriate.

In addition, consideration needs to be given as to how a Russian Stewardship Code would be enforced, especially if it operates on a 'comply or explain' approach, as with the UK Stewardship Code and many of its counterparts. In this regard, it is relevant to note that the enforcement of the UK Stewardship Code is underpinned by provisions in the Conduct of Business Rules of the Financial Conduct Authority, which is the primary regulator of asset owners and asset managers operating in the UK.

RECOMMENDATIONS

Enabling effective investor stewardship and responsible shareholder engagement is no longer an optional extra for capital markets. ESG investing has arrived and it is increasingly being integrated into institutional investment processes. The benefits that accrue serve to contribute to the sustainable prosperity of shareholders, stakeholders and, ultimately, society.

By virtue of preconceptions, the prevalence of state-controlled enterprises and concerns about enforcement and other cultural issues, the global investment community may be sceptical as to whether a Russian Stewardship Code will achieve its intended purpose. Irrespective of whether such scepticism is justified, it is in the gift of the Moscow International Financial Centre, the Bank of Russia, the Moscow Exchange and those who invest in securities to ensure that both the spirit and substance of a Russian Stewardship Code is implemented and enforced effectively.

Therefore, it is recommended that the following steps be taken to progressively develop and support a Russian Stewardship Code and related Responsible Shareholder Engagement Guidelines.

Recommendation one: to establish a high-level steering group. Its main purpose should be the overseeing of the steps necessary to enable a credible and progressive approach to investor stewardship in Russian capital markets. This is to include the progressive development, implementation and enforcement of a Russian Stewardship Code and related Responsible Shareholder Engagement Guidelines in respect of investors in securities listed on the Moscow Exchange.

The steering group could be co-chaired by senior representatives of the Bank of Russia and API and comprise nominees of both organisations, including domestic and overseas investors, and issuers with securities listed on the Moscow Exchange, as well as the Exchange itself.

Recommendation two: to set up a working group reporting to the high-level steering group to develop and maintain a Russian Stewardship Code and Responsible Shareholder Engagement Guidelines in respect of companies listed on the Moscow Exchange. The working group should be co-chaired by nominees of Bank of Russia and API, who are also members of the high-level steering group in order to ensure both groups are joined up. The working group's terms of reference should include a responsibility to recommend:

- Changes to Russian law and regulation when it is commensurate with achieving effective investor stewardship and engagement.
- Proposals for the review the Russian Stewardship Code and the Guidelines for Responsible Investor Engagement at regular intervals.
- Arrangements to integrate bond investors in order to enable them to fulfil appropriate stewardship and responsible engagement responsibilities.
- Proposals for training investors and issuers in ESG issues in order to develop and maintain competence therein.

Importantly, because it is envisaged that a Russian Stewardship Code and the Responsible Investor Guidelines would work alongside the Russian Corporate Governance Code, consideration should be given to bringing the latter within the scope of both the steering and working groups in order to ensure the Codes and Guidelines are aligned in all respects.

Recommendation three: that the Bank of Russia as a shareholder, Russian Direct Investment Fund, Sberbank Asset Management and other significant investors in companies with securities listed on the Moscow Exchange be encouraged to become signatories to the Russian Stewardship Code and supporters of the Responsible Investor Engagement Guidelines.

Recommendation four: the API, in consultation with the Bank of Russia, should highlight publicly examples of good investor stewardship and responsible investor engagement in order to both incentivise investors and issuers and to provide an informal benchmark for practitioners.

Recommendation five: the Bank of Russia, as part of its on-going initiative to make Russia's capital markets more robust and attractive to both foreign and domestic companies and investors, should sponsor an on-going series of roundtables or conferences – say, one or two a year – to explore ways to improve investor stewardship and engagement in Russia. Roundtable or conference participants should include academics, regulators, issuers and investors, both domestic and foreign.

CONCLUSION

The Moscow International Financial Centre, the Bank of Russia, and the Moscow Exchange, in cooperation with the API, have an opportunity to enhance the standing of Russian capital markets and make them more attractive and competitive by embracing investor stewardship and responsible investor engagement.

To achieve this, they should consider adopting and supporting the recommendations set out in this report and, as appropriate, proceed to oversee the development and implementation of not only a 'Russian stewardship code', but also Guidelines for Responsible Shareholder Engagement that are relevant and fit for purpose in a Russian context.

Importantly, they should ensure that a progressive and measured approach is adopted and that is credible at each and every stage in the eyes of the global investment community. It should be supported by a strategic communications programme to help provide effective, fair and balanced communication and visibility to those who will contribute, directly and indirectly, to the sustainable success of Russian capital markets.

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