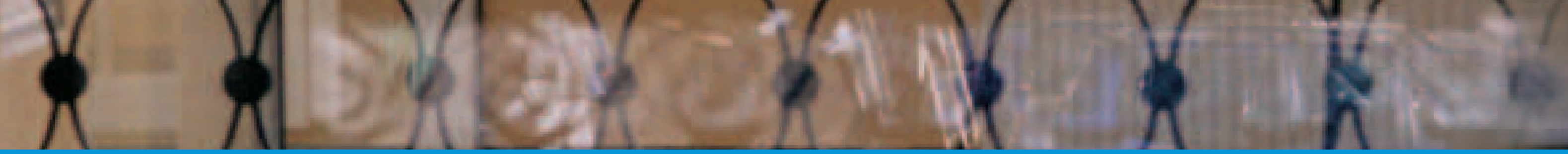
Law in transition 2006

Strengthening corporate practices

European Bank
for Reconstruction and Development



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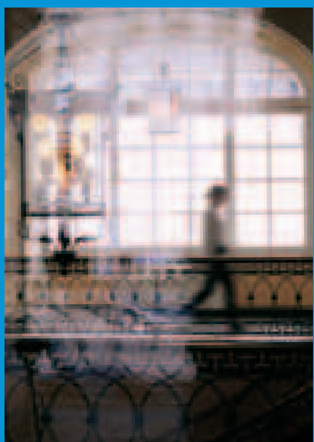

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The European Bank for Reconstruction and Development (EBRD) is an international institution whose members comprise 60 countries, the European Community and the European Investment Bank. The EBRD operates in the countries of central and eastern Europe and the Commonwealth of Independent States committed to multiparty democracy, pluralism and market economies.

The EBRD's countries of operations are: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Poland, Romania, Russia, Serbia and Montenegro, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

The EBRD works through the Legal Transition Programme, which is administered by the Office of the General Counsel, to improve the legal environment of the countries in which the Bank operates. The purpose of the Legal Transition Programme is to foster interest in, and help to define, legal reform throughout the region. The EBRD supports this goal by providing or mobilising technical assistance for specific legal assistance projects which are requested or supported by governments of the region. Legal reform activities focus on the development of the legal rules, institutions and culture on which a vibrant market-oriented economy depends.

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Foreword

Corporate governance in transition countries: putting theory into practice

Donald J. Johnston, Secretary General, OECD

Good corporate governance is essential for companies wishing to access external capital and for countries aiming to stimulate private sector investments. If companies are well run, they will prosper. Poor corporate governance weakens the company's potential and paves the way for financial difficulties and even fraud.

The Organisation for Economic Cooperation and Development (OECD) has been involved in building good corporate governance for a number of years. In 1999, the OECD published its Principles of Corporate Governance, the first international code of corporate governance approved by governments. Since 1999, these Principles have been widely adopted as a benchmark for good corporate practice. They are used as one of 12 key standards by the Financial Stability Forum for ensuring international financial stability and by the EBRD and the World Bank in their work to improve corporate governance in transition countries. The Principles were revised in 2004 with a series of new recommendations added.

The OECD Principles of Corporate Governance provide specific guidance for policy makers, regulators and market participants in improving the legal, institutional and regulatory framework that underpins corporate governance, with a focus on publicly traded companies. They also provide practical suggestions for stock exchanges, investors, corporations and other parties that have a role in the process of developing good corporate governance.

The Principles are a living document. It is an OECD priority to make sure that they are widely disseminated and actively used. This includes a continuing policy dialogue where policy makers, regulators and standard-setters from both OECD and emerging and transition countries can exchange their practical experience of implementing the Principles.

Regional roundtables on corporate governance, organised in cooperation with the World Bank, have proven to be an efficient avenue for this purpose. Three of these roundtables coincide with the EBRD's region and have seen the Bank's active participation in the discussions.

The Russian Corporate Governance Roundtable has developed 40 recommendations to improve corporate governance standards and practices in Russia. The roundtable is now looking at specific issues related to the implementation of key recommendations, including the control of related-party transactions and improved enforcement.

The Eurasian Corporate Governance Roundtable aims to improve the understanding and development of corporate affairs policies in Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Mongolia, Ukraine and Uzbekistan. The roundtable is currently focusing on enforcement through securities regulations and alternative dispute resolution.

The South East Europe Corporate Governance Roundtable has identified key areas for improvement in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Serbia and Montenegro and Romania. Furthermore, the roundtable has developed a set of practical recommendations for reform at a national and corporate level.

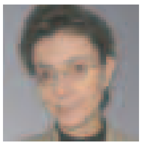
The work of the regional roundtables and the EBRD is now converging. This issue of *Law in transition* focuses on the implementation and enforcement of corporate governance legislation, acknowledging that good corporate governance needs functioning institutions and a sound environment to be effective. Being the largest single investor in the private sector in central and eastern Europe and the Commonwealth of Independent States, the EBRD is directly concerned with corporate governance.

Using the OECD Principles as a benchmark, the Bank completed in 2004 a corporate governance assessment of its countries of operations. The aim of the assessment was to encourage, influence and provide guidance to governments, policy makers and all those in charge of promoting new legislation for the development of corporate governance-related legal reform. The assessment shows how policy makers in a number of EBRD countries are acknowledging the importance of good corporate governance and are developing a legal framework in line with the OECD Principles.

Drafting good laws, however, is only part of the legal transition process. As demonstrated by the EBRD's Legal Indicator Survey in 2005, which focused on the effectiveness of corporate governance legislation, enforcement is now key. The objective for the future is to focus stakeholders' attention on putting formal rules into practice.

Donald J. Johnston

Primary infrastructure utility: the path to true, sustainable competition in telecommunications



Meni Styliadou
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This article discusses the impact of separating telecommunications infrastructure from services, highlighting the benefits of increased competition, greater efficiency and better regulation. Four different models for de-coupling the infrastructure are presented and the viability of each assessed.

No matter how attractive a product, without an efficient distribution system there is little chance of selling it. This applies to industries across the board, especially the telecommunications sector. The particular problem for telecommunications companies is that access to customers is very expensive and that most of the cost is assumed by the local access network.

By comparison, a traditional core network, the equivalent of the motorway in the transport world, is relatively inexpensive. This explains why the local network (the telephone connection in people's houses) has remained substantially unchanged, despite the huge telecommunications investments of the last few years.

Perhaps surprisingly, the bulk of the cost centres on civil works, digging trenches and building structures to house the equipment. There is a consensus within the industry that the cost of civil infrastructure represents 70 to 80 per cent of the cost of a fixed local access network. Infrastructure-based competition within the access network and the ability to offer greater speeds than an asymmetric digital subscriber line (ADSL) will only happen when this barrier can be overcome.

Primary infrastructure

Primary infrastructure is the civil infrastructure around a network, it includes ducts, dark fibre, co-location facilities, tall masts and sites for equipment. Operators of cable television, fixed-wireless, mobile phone, digital subscriber line (DSL) or fibre-to-the-building services can all share the same civil infrastructure. This is similar to different companies sharing one office block or different cars being driven on the same road. Sharing this infrastructure will not have an adverse impact on competition. On the contrary, it allows operators to save money that can then be invested in innovative services and content.

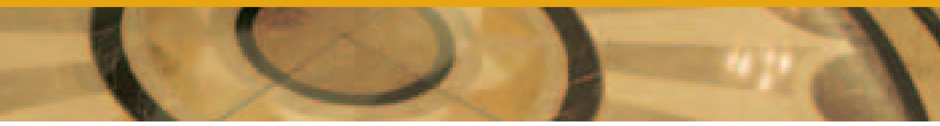
Naturally, the existing operators ("incumbents") dislike the idea of opening up their civil infrastructure to competitors since it is, after all, a major source of competitive advantage. The substantial investment necessary deters newcomers and acts as a barrier to entering the tele-communications market. New entrants have also struggled to gain access to ducts via the regulator. There is a range of reasons why access proved unfeasible: existing ducts may have collapsed or been difficult to locate, there may be no manholes to facilitate deployment of new cables or the ducts may simply be full. In summary, sharing the existing civil infrastructure of the incumbents is, in many cases, impractical.

The costs of civil infrastructure

One of the reasons behind the telecommunications frenzy of the late 1990s was the incredible advancements in communications technology. When investors discovered the immense possibilities offered by optical communications, they conceived of virtually infinite opportunities.

Optical telecommunications would allow multiple video conference links of a quality similar to digital television. It would also enable consumers to check on the safety of their houses

If a third party owned the telecommunications infrastructure, the biggest barrier to entry into the market for new operators would be removed. A third party provider would strive to attract as many operators as possible in order to maximise revenues.



and children, consult a specialist doctor hundreds of miles away on specific medical problems, remotely visit museums and libraries all over the world, watch at their convenience any film, documentary or sport event that has ever been digitally recorded, and discover new ways of interactive entertainment, education and shopping.

However, these visions never truly materialised because the cost of digging trenches was too high. New operators only replicated a fraction of the incumbents' local access networks even at the peak of the telecoms boom. Expansion is even less likely now, at a time when the operators' business model is being seriously questioned.

Incumbents are also unlikely to invest heavily in upgrading their infrastructures. There are two main causes for this reluctance:

- lack of competitive threat
- the obligation imposed by regulators to provide access to competitors and thereby eliminate any competitive advantage.

Primary infrastructure and transition economies

The high cost of primary infrastructure exists in both the developed and the developing world. It is, however, even more acute in the developing world where the cost of civil works delays the deployment of any fixed network infrastructure and pushes these countries to cheaper, wireless solutions. The predicament of wireless solutions is their limited capacity in terms of bandwidth. This poses no problem for voice communications but clearly affects the type of applications that can be accessed.

The new e-health and e-learning applications that could revolutionise the world of medicine or education in the developing world require sizeable amounts of bandwidth that simply cannot be delivered via a wireless network. There is thus a great risk that the digital divide will evolve into a new divide between those who can access and benefit from the convergence world and those who will be left out because of the cost of the civil infrastructure.

A different approach

One solution to the problem is a "third party primary infrastructure model". Under this model, a third party owns and manages the primary infrastructure and leases it to operators. The third party can be a private company with experience in infrastructure management, or a public-private partnership.

The civil infrastructure for telecommunications networks presents the same features as any other transport infrastructure such as roads, rail, gas pipes or the electricity grid. Furthermore and contrary to general belief, this is an infrastructure that supports all types of "next-generation networks" regardless of technology. Universal mobile telecommunications system (UMTS) networks need tall masts and ducts to connect their sites, cable TV networks need ducts and sites to house their equipment, optical network or very high bit-rate digital subscriber line (vDSL) network operators rely on ducts and dark fibre to carry their traffic.

If this civil infrastructure were owned by a third party, the biggest barriers to entry for new telecommunications operators would be removed. A third party primary infrastructure would strive to attract as many operators as possible in order to maximise its revenues. It would have no incentive whatsoever to discriminate among the various clients or their technologies since its interests would be best served by attracting the highest possible number of operators.

Third party infrastructure providers could be 100 per cent privately owned companies or public-private partnerships. There are a wide variety of models that could be adopted for the build, operation and ownership of the primary infrastructure. A number of these models with their advantages and disadvantages are discussed in this article. This concept has already been endorsed in France, Ireland, Italy, Spain, Sweden and in some US states.

Three cardinal rules, however, need to be followed in order for the model to be successful:

- The primary infrastructure provider should not be allowed to provide telecommunications services to the general public. As a result, its only way of maximising returns is by increasing infrastructure capacity and being an ally to all operators.
- The rate of return of this infrastructure must be regulated to avoid excessive pricing.
- Existing operators should be given the option to sell existing ducts, sites, masts and co-location spaces to the primary infrastructure provider. This will not only avoid unnecessary infrastructure duplication but will also permit some operators to use this cash to improve their services for clients.

How to make it work

A third party primary infrastructure provider can, in effect, be anybody interested in running a utility. A utility has a very long life cycle, similar to that of real estate. As such it can only be seen as a long-term investment. The difficulty is that it is also a low-return investment. Hence, similar to other utilities, the only way to make it attractive to potential investors is to offset the low-return factor with the low-risk factor. There are many investors who are interested in a low-risk investment proposition. This is, in fact, how utilities are usually financed.

Risk can be reduced in several ways:

- by granting an exclusive franchise for a period of time sufficient for them to amortize their investment
- through investing public money in the venture (as happens in some European countries) which grants a de facto concession.

The first risk-reducing approach does not have any negative impacts on competition in the telecommunications

The second method of investing public money leads practically to the same result; it is highly unlikely that the market would be contested by another private party without public subsidy. As a result, here again the infrastructure manager should be prevented from providing any telecommunication services.

Duplication of existing infrastructures

An added advantage of a third party primary infrastructure model is that it can be deployed as a way to restructure and refinance the telecommunications sector. The civil infrastructure represents a strategic asset for the incumbent mainly because it is not contestable. The cost of replication is prohibitive, and as a result the civil infrastructure protects the incumbent from any potential competition to its fixed network services. However, if a government is determined to resolve this bottleneck by creating an alternative civil infrastructure, the incumbent has no reason to maintain the ownership of its existing civil infrastructure.

By doing this, incumbent operators would reduce the assets on their balance sheet, while at the same time gaining access to cash and the opportunity to invest in developing services and content. Ultimately, it is the services and content that generate revenue for operators.

Public funding

Public funding might not be necessary. A number of infrastructure projects in the world have been financed through private funding. However, there may be areas where the business case for private investors is too weak and some public investment is required. This is a classic case for intervention by local and regional governments who have an obvious interest in improving the economic attractiveness of their area. Public investment can help to give private investors reassurances about the level of risk.

Telecommunications is the backbone of the knowledge economy. It is critical this infrastructure is built to the highest standard and kept open for all types of services and applications to flourish.

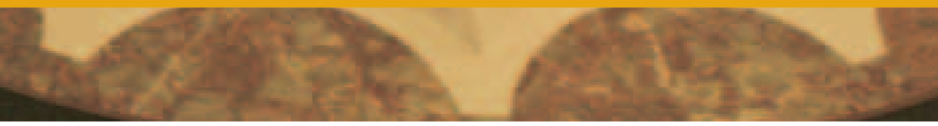
market. On the contrary, exclusive franchises lower the entry barriers and enhance competition in networks and services. This is the case as long as the third party primary infrastructure manager limits its activities to the deployment and management of this infrastructure without providing equipment or services.

The most sensible solution would be for the incumbent to sell its civil infrastructure to a third party. It could then lease back the capacity it needs. This would be similar to any other sell-leaseback agreement that businesses have negotiated for real estate assets.

Possible risks

There is an obvious temptation for third party infrastructure providers to start offering services, for example, in less affluent areas where operators may still be reluctant to do business. This might lead to the creation of new, small, vertically integrated local monopolies "subsidised" through a public-private partnership. This would not be a desired outcome.

In transition economies, there is a great opportunity to accelerate infrastructure development and create a market that allows true competition in services and applications.



Telecommunications is no longer limited to transporting voice and some basic data. It is the backbone of the knowledge economy. It is thus critical that this infrastructure is built to the highest standard and kept open for all types of services and applications to flourish. Innovation is the driver for growth and that requires competition. This is why it is important to identify the parts of the value chain that constitute a true natural monopoly, contain them and separate them from the parts of the value chain where competition can thrive.

Understandably, there may be areas where operators are reluctant to develop services even if there is an open-access primary infrastructure. This might represent an enticing premise to allow the primary infrastructure utility to move into added service provision. This, however, would be a mistake.

A distinction between a structural failure and a temporary market failure should be drawn. Primary infrastructure, on the one hand, has the features of a natural monopoly in both the urban centres and the rural peripheries. Network operators, on the other hand, will happily address the needs of some areas but not others. This may change in the future when demand becomes more consolidated and the business needs to respond accordingly. Such gradual intensification can be observed in the development of mobile telecommunications operators.

Temporary market failures need to be addressed with temporary measures. There may be a need for public subsidies to kick-start business in areas where there is not yet a clear demand for a commercial network operator.

These subsidies should be given to a separate legal entity which is completely independent from the provider which owns and operates the primary infrastructure. Maintaining legal separation between these two entities is critical for ensuring that competition will emerge when the time is right. Condemning poorer areas to an eternal monopoly would lead to a sustained digital divide.

The primary infrastructure model and transition economies

This model would be suitable for transition economies, possibly even more so than for developed countries where a certain amount of inter-platform competition has already emerged and a number of vested interests defend the current state of affairs. In transition economies, there is still a need for additional expansion of the basic infrastructure. There is thus a great opportunity to accelerate developments and create a market structure that would allow true competition in services and applications from the outset.

De-coupling infrastructure from services

There are plenty of examples proving the feasibility of a third party primary infrastructure model. However, all real-life examples involve some public funding, mainly because policymakers find it hard to admit that parts of the value chain may, after all, be a natural monopoly. As discussed earlier, utility investors require a low level of risk that can only be ensured with either public subsidies or the promise of exclusivity. Current telecommunications laws do not allow for exclusivity. As a result the only option remaining is that of subsidies.

There are many variations in the way these publicly funded projects are being structured. Not all of them, however, follow the principles outlined in this article. They can be divided into four broad categories, each one with its advantages and disadvantages.

Community-owned networks and telecommunications service providers

In this model, local governments build and operate a telecommunications network and provide services to end-users. Alternatively they may enter into a public-private partnership with a private firm. In this case, communities intervene in the first three levels of the value chain (see Chart 1).

Advantages
This model offers an immediate solution to all the broadband needs of the community. It is particularly attractive to rural areas where there is a low level of telecommunications expenditure or where residents and businesses are widely dispersed over a geographic area.

Disadvantages
The model is likely to impose an eternal monopoly. The public sector or the public-private partnership risk displacing commercial operators at all three levels, namely passive infrastructure, networks and services.

Carriers' carrier model

In this model communities build and operate "wholesale" broadband networks and lease "raw" bandwidth to operators. Again, they may do this on their own or through a public-private partnership. Service providers lease space in the co-location data centre for their equipment and bandwidth to deliver their services.

In this model the public sector intervenes in the first two levels of the value chain. In doing so, it lowers the entry barriers for private investment in the third level (see Chart 2).

Advantages
Community investment in infrastructure and networks significantly lowers the cost to communications service providers and content providers. It also allows them to extend their services to areas where it would have otherwise been prohibitively expensive to invest.

Disadvantages
In this model, the public sector intervenes in the first two layers of the communications networks. There is therefore a risk of displacing private investment in these first two layers or indeed restricting competition in networks and technologies.

A common variation of this model creates two legal entities. The local authorities only invest in the passive infrastructure assets, and retain the ownership of these assets. The private sector invests in creating a wholesale network operator that will be the tenant of the assets. The public sector agrees to award exclusivity over the usage of these passive infrastructure assets to the wholesale operator for a limited number of years. This exclusivity limits the risk to the private investor, while permitting local authorities to safeguard the long-term possibility of competition within the second layer (that of communications networks).

Primary infrastructure model

In the primary infrastructure model, communities create the passive infrastructure for telecommunications networks to be leased to operators. Passive (or primary) infrastructure includes ducts, masts, dark fibre, co-location sites and other civil structures necessary for the deployment of communications networks.

Chart 1 Community-owned networks and telecommunications service providers

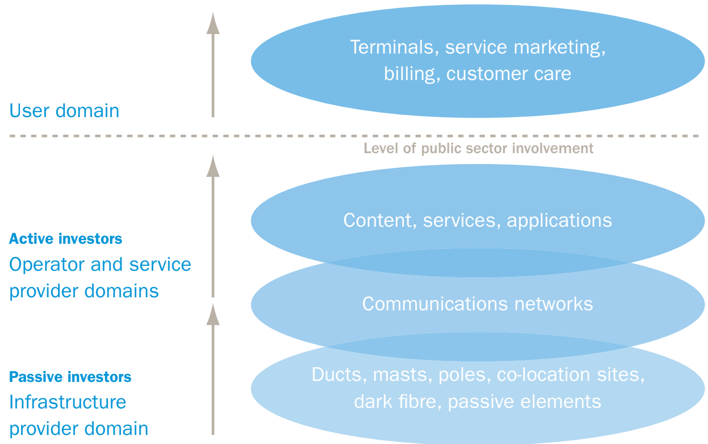


Chart 2 Carriers' carrier model

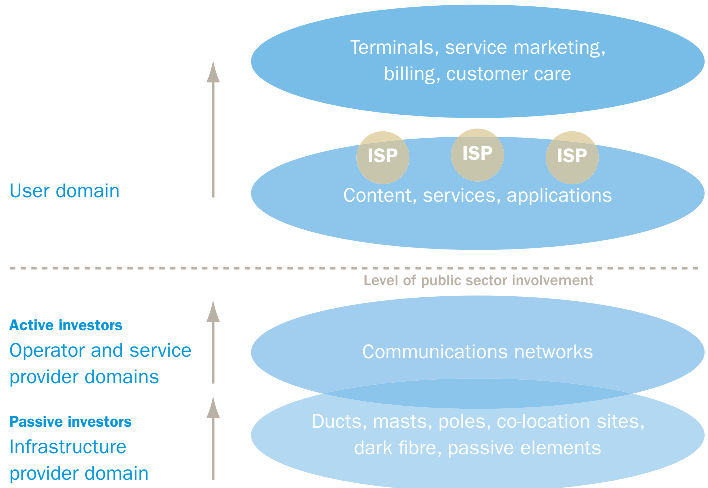
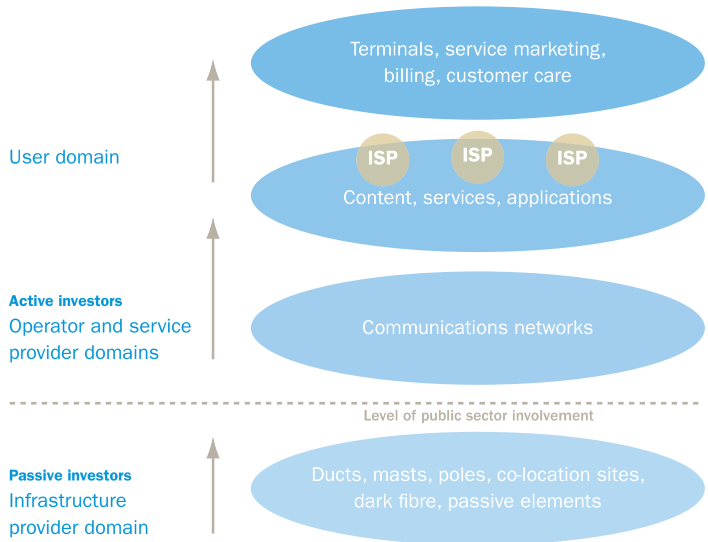


Chart 3 Primary infrastructure model



Note: ISP stands for internet service provider.

Source: Corning Incorporated.

Community investment in infrastructure and networks significantly lowers the cost to communications service providers and content providers. It also allows them to extend their services to areas where it would have otherwise been prohibitively expensive to invest.

In this model the public sector intervenes only in the first level of the value chain. This is, however, the biggest entry barrier for a telecommunications network. The passive infrastructure represents 70 per cent of the cost of a new fixed network and often nearly 40 per cent of the cost of a wireless network (see Chart 3).

Advantages
This model shares most of the advantages of the “carriers’ carrier model”. In addition, this model enables the public sector to intervene only at the lowest level of the value chain. This intervention enhances competition in all higher levels of the value chain, such as networks, technologies, services and content. This type of public intervention at such a low level is generally considered as competition neutral.

Disadvantages
This model still requires a sizeable investment from network providers in the active parts of the network. Thus the entry barriers for network operators, in particular service providers, would be higher than in the “carriers’ carrier model”. (In that model the network is already activated and service providers only need to make a very small initial investment.)

This problem, however, can be addressed by creating a separate entity to own and operate the network. A clear structural separation between the passive infrastructure entity and the entity owning and managing the network safeguards competition neutrality. It also ensures an anchor tenant for the infrastructure from day one.

Aggregation of demand

This final strategy focuses on having a large enough critical mass to provide an incentive for upgrading the network. The community tries to join together core user groups to provide a guaranteed level of demand, and thus revenue stream, to commercial broadband access providers.

Municipalities try to aggregate demand:

- from government and public entities, including local government entities, education service providers and health service providers
- from the private sector through agreements with businesses or even individual users through pre-registration schemes. Regional or local internet service providers (ISPs) and major regional businesses are usually the first targets for these agreements.

Advantages
This model of intervention bears no financial risk for the public sector. It does not require any cash investment and the public sector does not need to develop any particular technical expertise.

At the same time, it reduces the financial risk for the private sector and it allows a faster and more effective deployment of broadband services in the area.

Disadvantages
This model improves the business opportunity of one broadband access operator but destroys it for all the others. If a considerable part of the community is locked in a contract with one operator, there is very little business opportunity for any competing operator. This foreclosure effect has some long-term implications. If an operator has used the demand aggregation to make some sizeable infrastructure investments, there is a great chance that no other operator will duplicate these assets for the foreseeable future.

However, this problem can be addressed if aggregation of demand is being used in conjunction with one of the other models, such as open-access passive infrastructure. In this case, local authorities would invest in open-access passive infrastructure while at the same time aggregating demand to attract an operator to invest in the network.

The supply agreement with the operator would have a limited duration. The operator may be concerned that, in view of the relatively low entry barriers into this market, the authorities may decide to switch operators at the expiry of this supply agreement. A combination of these two models may address the weakness of both models in the optimum manner.

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Fighting money laundering and terrorism finance

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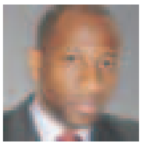


Liévin Tshikali,
Compliance Manager, EBRD

In 2005 the EBRD launched an ambitious programme aimed at raising awareness of money laundering in its countries of operations. This article describes the work being undertaken by the Bank to promote anti-money laundering measures in the financial sector.

International efforts to combat money laundering began with the United Nations Vienna Convention in December 1988 and the Council of Europe Convention in 1990.[1] The Vienna Convention introduced an obligation to criminalise the laundering of profits from drug trafficking and initiated measures to improve international cooperation. Heavier penalties were introduced under the Council of Europe Convention including investigative assistance, search and seizure and the confiscation of earnings from all types of criminal activities.

These penal measures were introduced in tandem with further preventative work undertaken by the Basel Committee on Banking Supervision which issued its declaration against money laundering in 1988.[2] The Financial Action Task Force on Money Laundering (FATF) set up by the Group of Seven industrialised countries at its Economic Summit in Paris in July 1989 is following up these initiatives.[3] The FATF thus remains the main international agency in this area and continues to make a significant contribution towards developing best practice and improving cooperation in combating global money laundering.

Its 40+9 recommendations have now become the global blueprint in anti-money laundering best practice.

Although in place for some time, such efforts have become even more important since 11 September 2001 as countries attempt to develop new global alliances to challenge significant criminal and terrorist threats. Financial institutions are thus subject to several separate criminal and regulatory requirements on anti-money laundering (AML) and the prevention of terrorist activities. The overall thrust of these rules is:

- to attempt to prevent financial institutions from being used as a cover for criminal purposes
- to use in-house banking information, systems and controls to detect such activity
- to allow separate prosecution and enforcement.

Strengthening transition economies also means promoting transparent financial markets. Therefore, promoting AML training is an integral part of the EBRD's activities and ultimately forms part of its transition mandate.

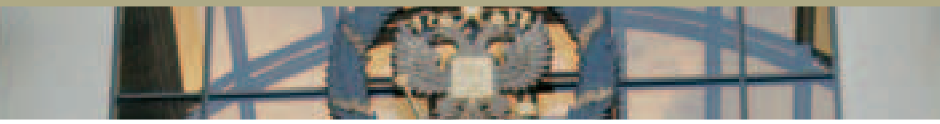
The EBRD's efforts towards AML have, of course, been guided by its institutional focus on private sector companies and in particular financial institutions. This has meant that in previous years the Bank's strategies have mainly concentrated on thorough internal due diligence in order to ensure the efficiency of their potential clients' AML policies, making sure none of them were involved in money laundering activities.

The Bank has developed its AML programme further, driven by the following questions:

- Why is AML a key priority for the Bank?
- What is the Bank's role, from an AML perspective, in its countries of operations?
- How can the EBRD help address the issue?

The purpose of this article is to describe the work of the EBRD in promoting AML in its countries of operations. It presents the outcome of three pilot projects, the overall project process and design, current implementation and early indications of the results of the programme itself.

In most of the EBRD's countries of operations, the authorities have made significant efforts to tackle money laundering. This has included adapting their legislation and setting up institutions with effective powers of enforcement.



Why should AML be a key priority for the EBRD?

Measuring the scale of money laundering worldwide is difficult. In several International Monetary Fund (IMF) and FATF publications, a "consensus range" of 2 to 5 per cent of the world gross domestic product is frequently reported. This range is said to be between €500 billion and €1.3 trillion per year.[4] However, all experts agree that the real magnitude of money laundering is significantly underestimated.

AML is a key priority for a number of reasons. First, the Bank must adhere to international standards and promote the rule of law in its countries of operations.

Secondly, the Bank requires high ethical standards in all of its operations. Since the proceeds of illegal activities such as corruption, organised prostitution networks and drug trafficking are channelled into the financial system through laundering techniques, making anti-money laundering a priority indirectly helps to combat such activities.

Finally, money laundering poses great risks:

- at the country level, since it is a threat to any kind of sustainable development. Experience has shown that sustainable growth is impossible in situations where there is a high level of organised crime and corruption.
- at the financial sector level, because money laundering undermines financial soundness and stability. A financial centre needs a sound reputation to attract sound investment. When a country or place is reputed for its complacency it is likely to attract further financial misdemeanours and discourage legitimate investors fearing for their own reputation.[5]
- at the bank level, because being a victim of money laundering indicates a lack of research into the client rather than a deficiency of thorough risk assessment. Good business practice and AML provisions go hand in hand. Banks need to know who their clients are. Failure to meet these requirements exposes the institution to fraud, bad debt and all kinds of financial crime. The aftermath of money laundering and the ensuing regulatory sanctions would not only attract negative publicity, but would also incur costs from the upgrading of systems and procedures. There is also a possibility of legal costs if the Bank were to be prosecuted, or if it were to take legal action against its client.

Where do we stand in eastern Europe?

Overall, the situation is improving. In most of the EBRD's countries of operations, the authorities have made significant efforts to tackle money laundering. Countries that used to be on the FATF non-cooperative countries and territories blacklist have been removed: Hungary in June 2002, Russia in October 2002 and Ukraine in February 2004. These moves show that efforts from these countries, and several others that have never been on the list, to adapt their legislation and set up institutions with effective powers of enforcement have been successful (see Table 1). This is mainly the case of central European countries and, to a lesser extent, the Western Balkans. The central European countries have been driven by the European Union (EU) accession process and the need to enforce EU anti-money laundering directives. Since October 2004 most countries in the Commonwealth of Independent States (CIS) have been charter members of the new Eurasian group on combating money laundering and financing of terrorism. This newly created group is a FATF-style regional body. Other countries have recently introduced AML laws that are under FATF assessment.

Government commitment and the proper legal framework is one thing, enforcement at the micro level is another. AML measures are only effective if financial institutions understand the risk involved and commit to their implementation. The EBRD's work provides a good view of what happens at the micro level. The EBRD, as the most important single financial investor in the region, has over 256 financial institutions as clients (of which 184 are banks).

Thus, in 2002, the Bank conducted a review of AML policies developed by its countries of operations and by its clients. Over a period of 12 months the Bank wrote to all its clients to raise awareness of AML and to gather information about their AML policies and procedures. The Bank also collated data on AML legislation and enforcement mechanisms for each country of operations. The purpose of this stocktaking exercise was twofold: first, to understand the AML policies of our clients and to develop, if needed, suitable training; and secondly, to engage the governments and AML authorities in policy dialogue. As a result of the review, the Bank's countries of operations fell into three broad categories:

- Group one: countries that have an AML system in place which works reasonably well. This group includes EU member states and accession countries.

- Group two: countries that employ an AML system which is more or less untested. This group includes mainly the Western Balkan countries and some CIS countries.
- Group three: countries that either do not have an AML system in place or have a distorted AML system (for example, the secret service is in charge of financial investigation). This group includes many Central Asian countries.

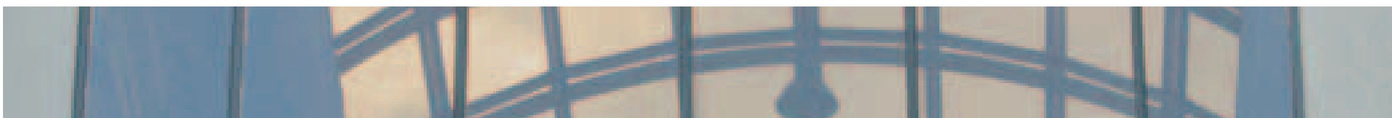
Two conclusions arose from the identification of these categories. First, as the AML systems of the first group of countries functioned well and, as the European Community (EC) was already engaged there, the Bank did not consider that its involvement would add considerable value.

How can the EBRD help address the issue?

The pilot seminars highlighted the need for anti-money laundering training in countries that had not yet benefited from commercially run courses. Even if such seminars were available their high costs would usually prohibit these countries' money laundering compliance officers from attending.

The main concerns expressed by delegates attending the seminars concerned legislation and how it affects banking. They also expressed concern about the different types of suspicious transaction reports that will need to be submitted to their respective Financial Intelligence Unit (FIU).

This second review found that the participating countries were at different stages of implementation in their AML and CTF requirements. In many countries – like Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Georgia, Moldova, Romania, Russia, Serbia and Montenegro (including Kosovo) and Ukraine – money laundering had, to varying degrees, already been the subject of conferences and other events, run by different international bodies and by the local regulatory agencies.[7] Russia and Ukraine, for instance, had already been recipients of EU funds for large programmes such as MOLI-RU and MOLI-U.[8] These programmes were institutional in focus, concentrating on the setting up of AML structures, such as the FIU, and the promulgation of internationally compliant legal frameworks.



In 2005 the Bank conducted training seminars in 15 countries, aimed at raising awareness and increasing knowledge of money laundering and terrorism financing risks.

Secondly, the potential clients (groups two and three) represented a broad spectrum. Therefore, a one-size-fits-all approach would not have addressed the different needs within these groups. For this reason the Bank has launched two pilot training courses: one for banks from countries in the second group and the other for banks and regulators from countries in the third group. The latter consisted of two separate initiatives:

- developing an action plan with the national regulator to introduce a suitable AML system
- training for banks and regulators to increase awareness of AML.

Three pilot seminars were undertaken over two days in Bosnia and Herzegovina, FYR Macedonia and Kazakhstan.

Building on these pilot seminars, the Bank's consultant visited 15 countries from January to early April 2005.[6] The aim was, once again, to gather detailed information on how each country addressed:

- the criminal definition of AML and counter terrorism financing (CTF)
- offences and penalties
- customer identification
- "know your customer" and due diligence requirements
- account monitoring
- suspicion reporting
- record-keeping
- the implementation of international recommendations
- staff training.

Although these programmes had been successful in producing high-level awareness of international requirements and setting the legal and political framework within which the AML regime operated, they, for the most part, had not penetrated to the second level (product typologies, suspicious transaction recognition examples and account analysis) which is instrumental in training bank staff.

Other countries like the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan had received hardly any, or no, attention at all. In some countries the subject was viewed as politically sensitive, although there was great interest from bankers and officials.

Table 1 Anti-money laundering measures in transition countries

	Specific legislation addressing money laundering
Albania	Law on the prevention of money laundering (no. 8610), dated 17 May 2000; amended (no. 9084), dated 19 June 2003.
Armenia	While there are provisions within different laws prohibiting money laundering, as of June 2005 there was no specific piece of legislation addressing money laundering. There is, however, a draft law on money laundering and terrorism financing currently being circulated by the government.
Azerbaijan	Law on banks, dated 16 January 2004; rules for professional participants of the securities market for the purpose of preventing money laundering and financing of terrorism, dated 9 March 2004.
Belarus	Law on measures against the legalisation of incomes received by criminal means, dated 19 July 2000.
Bosnia and Herzegovina	Law on money laundering, adopted in 2004 at the state level.
Bulgaria	Act on measures against money laundering, dated 24 July 1998.
Croatia	Act on anti-money laundering, as amended, adopted 18 June 1997.
Czech Republic	Act on measures against legalisation of proceeds from criminal activity (no. 61/1996).
Estonia	Act on money laundering and terrorist financing prevention, adopted 25 November 1998, as amended.
Georgia	Law on preventing the legalisation of illegal revenues, adopted 6 June 2003.
Hungary	Act XV of 2003 on the prevention and impeding of money laundering, effective 16 June 2003.
Kazakhstan	While there is no specific legislation addressing money laundering, Article 193 of the Criminal Code prevents the legalisation of money or other unlawfully acquired property.
Kyrgyz Republic	In 2004 the Kyrgyz legislature drafted a fairly comprehensive law on combating terrorism and illicit money laundering. On 9 December 2004 the bill passed its first reading in the parliament.
Latvia	Law on the prevention of laundering of proceeds derived from criminal activity, adopted 18 December 1997, as amended.
Lithuania	Law on the prevention of money laundering (no. VIII-275), adopted 19 June 1997; current version effective as of 1 May 2004.
FYR Macedonia	Law on the prevention of money laundering and other proceeds from crime, adopted July 2004.
Moldova	Law on the prevention and combating of money laundering (no. 633-XV), adopted 15 November 2001, as amended.
Poland	Act on counteracting the introduction into financial circulation of property values derived from illegal or undisclosed sources, approved June 2001, as amended.
Romania	Law on the prevention and sanctioning of money laundering (no. 656/2002), as amended.
Russia	Federal law on counteraction to the laundering of incomes derived by means of crime and terrorism financing (no. 115-FZ), dated 7 August 2001, as amended.
Serbia and Montenegro	
Serbia	Act on money laundering (Official Gazette of FRY, no. 53/2001), promulgated 27 September 2001.
Montenegro	Act on money laundering and terrorism financing prevention, dated 1 October 2003; amended 18 March 2005.
Slovak Republic	Act on the protection against the legalisation of proceeds from criminal activities (no. 367/2000 Coll.), adopted 5 October 2000, as amended; effective from 1 January 2001, as amended.
Slovenia	Act on the prevention of money laundering (Official Gazette of the Republic of Slovenia, no. 79/2001, 59/2002), as amended.
Tajikistan	A specific law on money laundering is currently being discussed. At present there is only a clause in the Criminal Code (Article 262).
Turkmenistan	Article 242 of the Criminal Code, dated 12 June 1997, covers the legalisation of illegally obtained funds or other property and prohibits money laundering. There is, however, no comprehensive legislation on money laundering in Turkmenistan.
Ukraine	Law on the prevention and counteraction to the legalisation (laundering) of the proceeds from crime, dated 28 November 2002.
Uzbekistan	The parliament passed a new law in August 2004 to combat money laundering and and terrorist financing. This law is scheduled to take effect in January 2006.

No   Yes   na = no data available

Source: EBRD securities markets assessment 2005, based on legislation in place as of 31 May 2005.

	Market intermediaries required to have policies which minimise the risk of them being used as a vehicle for money laundering	Market intermediaries required to "know their customer" before providing specific advice	Financial institutions required to undertake customer due diligence, including identification and verification of their identity	Financial institutions prohibited from opening/maintaining anonymous accounts	Financial institutions required to report funds suspected of financing criminal activity
	■	■	■	■	■
	■	□	■	■	■
	□	■	■	■	■
	■	□	□	■	■
	■	■	■	■	■
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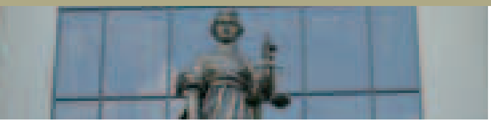
Laws and procedures cannot combat money laundering single-handedly. The real challenge is for countries to continue conducting regular training seminars and maintain permanent policy dialogue with the authorities.



The need for practical training for banks was obvious, but needed to be aligned within a wider educational context. These fact-finding visits allowed the Bank to consider the perceived training needs in each country and develop an AML/CTF training and awareness programme with the support of the EU and the Swiss State Secretariat for Economic Affairs (SECO).

The programme

The workshop series started in May 2005 and was due for completion at the end of November 2005. Each seminar was conducted over two days and targeted 20 to 30 people from financial institutions and their respective regulators, such as national central banks, FIUs and ministries.

Each seminar met the core identified training requirements and followed a "trainer friendly" concept, adaptable to local content. It combined presentations from local and overseas presenters with discussion opportunities and "train-the-trainer" sessions. Primarily, the seminars provided an overview of money laundering risks, policies available to banks, detailed structures and terminology and legal requirements with a focus on suspicious transaction recognition and reporting systems.

Various training tools were developed and used in these seminars including:

- *Money laundering: who cares?* A video introducing key AML/CTF risks and methods for combating them
- *Money laundering and terrorist financing*, a game-based exercise explaining the AML/CTF process
- *Money laundering: a country tale*, an audiovisual slide show of the processes and methods used by money launderers
- *Law quiz*, an audiovisual quiz resource providing foundation teaching on major legal and regulatory requirements about identification, "know your customer" (KYC), monitoring, suspicion reporting and record keeping
- *Identity fraud*, a set piece presentation on the massive growth of identity risk through the increase in use of credit cards, ATMs and the internet
- *KYC – mini scenarios*, a set of mini case studies covering suspicion recognition in a management context
- *Is it suspicious?* An account analysis exercise identifying patterns of suspicious transactions
- *The syndicate*, a video-based training exercise setting up money laundering typologies.

The translated audiovisual materials which were used gave local visual references such as cities, people, maps, currencies and economic data.

Programme results

Judging by delegates' satisfaction scores, the workshops have been successful. So far, 210 bankers from 177 institutions in ten countries have been trained on the programme. Of these:

- 96 per cent either "strongly agreed" (77 per cent) or "agreed" (19 per cent) that the programme was useful to them and their organisation
- 97 per cent either "strongly agreed" (78 per cent) or "agreed" (19 per cent) that they would recommend the programme to other bankers in their countries
- 77 per cent either "strongly agreed" (38 per cent) or "agreed" (39 per cent) that the programme was well adapted to their local environment.

Scoring strongly were the sessions dealing with suspicious transaction recognition and reporting, in many ways the most important issue for banks, with 97 per cent of delegates rating these sessions as either "very useful" (74 per cent) or "useful" (23 per cent).

The Bank will conduct a more detailed assessment of the programme in 2006 when all of the seminars have been completed. Each workshop had a final session entitled "Potential action for advancing the national AML effort" which invited delegates to express the priorities facing the banking sector. From the discussions, it is possible to identify the following distinctive, almost pan-regional, pattern of priorities from the workshops held so far:

- training – the need for more training of the kind delivered by this programme, dealing with practical day-to-day issues confronted by bankers while continuously adapting the programme to the local environment
- legal rationalisation and amendment – amending existing and draft laws to address the perceived lack of clarity and occasional inconsistencies with other areas of national law
- technology – the creation of suspicious transaction software, blacklist software and software to assist with compulsory reporting of large numbers of transactions to the authorities
- better liaison between agencies and commercial banks – in relation to such areas as expected best practice, clarification of circulars and official letters, consultation on proposed legislative amendments and agreements on mutual assistance.

Conclusion

The feedback forms and comments made during and after the seminars have demonstrated the value and importance of this programme in achieving the key objective of raising awareness and increasing knowledge of money laundering and terrorism financing risks in the Bank's countries of operations.

The overall success of the programme should be viewed in the context of existing legislation, levels of awareness and the current situation in most of the countries, which are not yet equipped to tackle the issue effectively. A distinction between the accession countries (in group one) and the Western Balkans and some CIS countries (in groups two and three) can be highlighted. Although the former have put in place the entire legal framework, effective enforcement remains very weak.[9] In the latter, particularly in most Central Asian countries, international standard money laundering frameworks have to be put in place before focusing on implementation and enforcement.

Hence, should this programme continue, it would focus more on the institution-building capacity of the Western Balkans and most CIS countries. In advanced countries driven by the *acquis communautaire* of the EU the priority will be enforcement. Targeting local legal professionals and enforcement agencies would considerably improve the situation.

In conclusion, laws and procedures cannot combat money laundering single-handedly nor can they protect any country, financial centre or bank from the serious repercussions of money laundering. To ensure that this matter remains uppermost in the minds of those on the ground, AML actions should continue to be promoted through regular training seminars and the maintenance of a permanent policy dialogue with the authorities. This is the real challenge in the transition countries with regard to money laundering. This ambitious programme is an important and welcome milestone towards this objective.

Notes

1 See United Nations, Convention against illicit trafficking in narcotic drugs and psychotropic substances (Vienna, 19 December 1988) and Council of Europe, Convention (Strasbourg, 8 November 1990), respectively.

2 Basel Committee, "Statement on the prevention of criminal use of the banking system for the purpose of money laundering", 12 December 1988.

3 Money laundering has been defined by the FATF as "the conversion or transfer of property, the concealment or disguise of its true nature or source, or the acquisition, possession or use of property knowing it to be criminally derived". The FATF stated that money laundering involves three general stages or phases of operation: placement, layering and integration of funds. While placement involves the physical disposal of bulk cash proceeds from their location of acquisition to avoid detection, layering is the separation of illicit proceeds from their source with complex financial transactions to disguise their audit trail. Integration then involves the conversion of the proceeds into apparently legitimate business earnings through normal financial or commercial operations in the real economy. For more information on the work of the FATF, see www.fatf-gafi.org.

4 How much of this can be accounted for by the proceeds of organised crime – as opposed to individual crimes and tax evasion – is likewise hard to estimate. Recently, the FATF established the Ad Hoc Group for estimating the magnitude of money laundering. An effort was made to develop a methodology to measure the sums involved, related to the production and trafficking of specific types of illegal drugs, from a global perspective. The effort was stopped mainly due to the lack of reliable data.

5 It is not surprising to see high numbers of potentially suspicious financial activities involving possible money laundering in some countries or "off-shore centres" that are praised for their competitiveness yet reprimanded for the opaqueness of the deals which can take place there.

6 Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Georgia, Kyrgyz Republic, Moldova, Romania, Russia, Serbia and Montenegro (including Kosovo), Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

7 The EU funds workshops in Armenia, Georgia and Moldova.

8 Money Laundering in Russia and Money Laundering in Ukraine.

9 It is found that in most of the EBRD's countries of operations, including some EU member states and accession countries, there is still a general absence of law enforcement results in terms of money laundering prosecutions, convictions and asset recovery. Few prosecutions for money laundering or terrorist financing have been reported.

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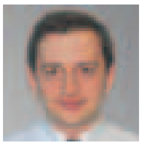
Mongolian commercial legislation: transition in progress

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Mongolia is expected to become an EBRD country of operations in 2006. In preparation, the Bank has been assessing the country's investment climate, particularly the legal frameworks for concessions, corporate governance, insolvency and secured transactions. The major findings are discussed in this article.

Mongolia became a shareholder of the EBRD in 2000 and is likely to become an EBRD country of operations during 2006. The Agreement Establishing the Bank has been amended accordingly and the process of ratifications is under way.[1]

Over the last year the EBRD has been assessing the conditions for potential investments in the country. In this context, a review of the main commercial laws was conducted, with the assistance of local law firms, reflecting the situation as at August 2005.[2] This article presents the major findings in four legal areas directly relevant to investment activities: concessions, corporate governance, insolvency and secured transactions.

Transition and legal reform in Mongolia

In the last 15 years the political, economic and legal systems of Mongolia have undergone major reforms. The constitution adopted in 1992, which is still in force, has created the foundation for a democratic state based on republican principles. The country had four parliamentary elections between 1992 and 2005, all of which were widely perceived as fair.[3]

The level of political stability is high and conducive to economic growth. After just three years of initial recession in the early 1990s, the Mongolian economy has been performing well at an annualised gross domestic product (GDP) growth rate of between 3 and 4 per cent. It has benefited from significant structural reforms and investor-friendly government policies.

Mongolia has a relatively small population (2.7 million including more than 1 million in the capital Ulaanbaatar) and a modestly sized economy.[4] Given these facts, the Mongolian leadership has adopted as its strategy an open internal market by encouraging foreign investments and trade. The trend is also towards adopting more commercial laws based on international best practices.

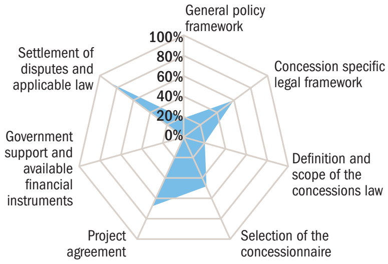
The last decade has seen the transition from a planned system towards a market economy. More than 500 laws regulating commercial activities have been adopted during the second half of the 1990s, regulating, among other things, commercial entities, tax matters, banking activities, securities markets, arbitration and currency exchange. The adoption of the Civil Code in 2002 has been a major step in laying the foundations of a modern civil law system. The proper implementation of its provisions through secondary legislation and court practice remains, however, a challenging goal for the local legislator and judiciary.

Concessions

Mongolia has at this stage a limited legal framework for the development of public-private partnerships in infrastructure and services. Chart 1, based on methodology developed by the EBRD Concessions Sector Assessment, indicates a need for improvement in virtually all dimensions of the concessions legal regime when compared with international standards.

Mongolia does not have a general policy framework for promoting public-private partnerships. There is no general law on concessions in place to date.

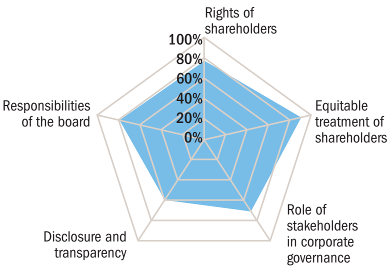
Chart 1 Quality of concession legislation



Notes: The extremity of each axis represents an ideal score in line with international standards, such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure Projects. The fuller the 'web', the more closely concessions laws of the country approximate these standards.

Source: EBRD Concessions Sector Assessment 2004-05.

Chart 2 Quality of corporate governance legislation



Notes: The extremity of each axis represents an ideal score in line with international standards, such as the OECD Principles of Corporate Governance. The fuller the 'web', the more closely corporate governance laws of the country approximate these standards.

Source: EBRD Corporate Governance Sector Assessment 2003-04.

The Law on State and Local Property provides for the transfer of state property to third parties by way of concession or leasing agreements with the approval of the authorised body.[5]

When it comes to land or subsoil, the matter must be specifically regulated by law. In the absence of a specific concession law, this type of arrangement may be granted under sector-specific laws such as the Petroleum Law, the Minerals Law, the Water Law, the Railway Transportation Safety Law, the Auto Transportation Law, the Health Law, the Law on Education and the Energy Law.

Generally, the Mongolian legal system does not contain extensive provisions on the scope and definition of concession-related agreements (see Chart 1). In particular, the Law on State and Local Property does not define the term "concession". Due to this insufficient regulatory framework, the level of flexibility in terms of concession agreements remains low. The Public Procurement Law requires a competitive selection procedure for granting concession-like agreements. In addition, it should be noted that the various sector-specific laws do not provide for compensation of concessionaires in case the licence is revoked (with the exception of the Minerals Law).

Mongolian law provides for a relatively developed regime of dispute resolution, including where foreign parties are involved. The Civil Code generally permits parties to a contract to choose the applicable law and to refer their disputes to arbitration. This flexibility will be of great use to concessionaires, as the relevant sector-specific laws do not preclude such arrangements. However, in some sectors the legislation provides for mandatory application of Mongolian law (for example, the Petroleum Law).

A number of members of parliament (the Great Hural) recently put forward a draft amendment to the Law on State and Local Property. This amendment would introduce a special chapter dealing with concession agreements. The draft reflects modern principles and standards applicable to concessions.

Corporate governance

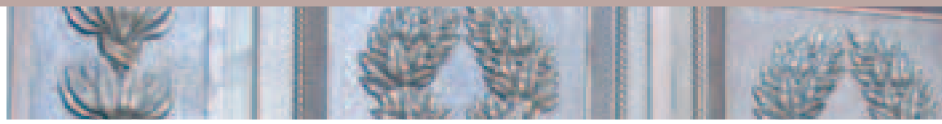
The corporate governance framework is regulated by the Civil Code and the Company Law that became effective in 1999. The latter plays a crucial role as its provisions establish the framework within which both domestic and foreign companies must operate. The Company Law has replaced and superseded the provisions of the former Partnership and Company Law that were applicable to companies before 1999.

The EBRD Corporate Governance Sector Assessment, which measured the extensiveness of the law or the quality of the "law on the books", found that overall corporate governance legislation in Mongolia was in "high compliance" with the international standards as set out in the OECD Principles of Corporate Governance.[6] Measured against such principles as a benchmark, it is especially strong in ensuring the equitable treatment of shareholders.

Certain areas such as disclosure and transparency requirements, judicial protection of shareholders' rights and issues related to the board of directors could, however, benefit from the adoption of a regulatory regime more consistent with international best practices (see Chart 2).

In 2005 the EBRD launched a survey for testing the effectiveness of corporate governance (how the law works in practice). A case study dealing with related-party transactions was designed. The case study investigated the position of a minority shareholder seeking to access corporate information in order to understand if a related-party transaction was indeed entered into by the company. The exercise particularly examined how it was possible to obtain compensation in case damage was suffered.

Corporate governance legislation in Mongolia (the “law on the books”) was found to be in “high compliance” with international standards such as the OECD Principles of Corporate Governance. It is especially strong in ensuring the equitable treatment of shareholders.



Effectiveness of legislation was then measured according to four principal variables: complexity, speed, enforceability and institutional environment.

The survey revealed several shortcomings in Mongolia. Procedures for obtaining disclosure and redress can be quite complex, especially if the company and/or the controlling shareholder refuses to spontaneously collaborate with the minority shareholder. As to the institutional environment, the survey evidenced that company information is generally not reliable while statutory auditors are usually unable to act independently. Both conditions lower the possibilities to obtain a successful disclosure.

The absence of case law offering guidance to the interpretation of the law also negatively influences the clarity of proceedings. The time needed to obtain an executable judgement was assessed to be around one year, but it is quite easy for the defendant to delay the process. Enforceability of judgements is reported as problematic. Usually, enforcement procedures are difficult and very time-consuming. When considering redress, the survey reported a lack of experience and competence of the lower courts in corporate law cases and their potential partiality. (This is especially true when the case is against a powerful defendant.) As a result, the effectiveness of corporate governance legislation in the country can be said to be generally low.

Insolvency legislation

Insolvency is governed by the Bankruptcy Law adopted in 1997. The Bankruptcy Law provides users with basic tools for initiating insolvency and resolving resulting conflicts. However, there remain numerous concerns about the function of insolvency proceedings and the lack of experience by trustees and courts. When assessed against international standards applicable to insolvency, as per the methodology of the EBRD Insolvency Sector Assessment, the Bankruptcy Law was in “low compliance” with such standards (see Chart 3).

The law states that insolvency shall be deemed to exist when the debtor is in default for an amount representing at least 10 per cent of its capital. Such financial conditions that allow for insolvency proceedings to be initiated against companies need greater clarification, particularly with regard to the maturity of overdue debt.

The law does not provide for mechanisms allowing the trustee to obtain information on the bankrupt company’s financial condition. Reorganisation financing is another area that is not sufficiently regulated. Finally, cross-border insolvency proceedings are not regulated by the Bankruptcy Law at all.

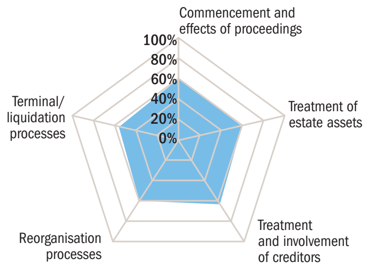
Secured transactions

Taking security in Mongolia is regulated by a number of laws. The general provisions are set out in the Civil Code which offers a relatively detailed framework.[7] In addition, the Law on Registration of Rights over Immovable Property contains important provisions for the perfection of mortgages. Enforcement issues are governed by the Law on Enforcement of Court Orders. Moreover, sector-specific laws include regulations that can apply under certain circumstances. For example, the Minerals Law has provisions that apply to the charge of mining licences.

Under the Civil Code, the charge creates a proprietary right: the asset is encumbered with the charge and the charge is an accessory to the secured debt.[8] There is no clear distinction between possessory and non-possessory charges. It is left to the parties to decide how they wish to structure their security. In the case of movable property, the charge holder may sell the charged asset directly in the event of default by the debtor.[9] In the event of insolvency and liquidation, secured claims are ranked second, only after claims deriving from contracts concluded during the reorganisation period (Bankruptcy Law).

Immovable property (apartments, production facilities) is used as collateral mainly for bank loans. A registration system is in place. It is run by the Agency for Registration of Land Property and Immovable Property Rights and is reported to be functioning properly.

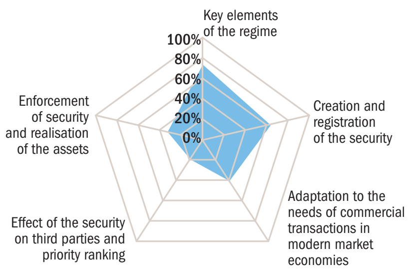
Chart 3 Quality of insolvency legislation



Notes: The extremity of each axis represents an ideal score in line with international standards, such as the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, the UNCITRAL Working Group on Legislative Guidelines for Insolvency Law, and others. The fuller the 'web', the more closely insolvency laws of the country approximate these standards.

Source: EBRD Insolvency Sector Assessment 2004-05.

Chart 4 Legal and practical regime for taking security over movable and intangible property



Notes: The extremity of each axis represents an ideal score in line with international standards. The fuller the 'web', the more closely secured transactions laws of the country approximate these standards.

Source: EBRD Regional Survey of Secured Transactions 2004-05.

As far as security over movable property is concerned, the legal framework is less developed. Although the Civil Code allows for registration of charges, a specific registration system does not yet exist. Taking security over receivables, vehicles or equipment is a possibility that Mongolian banks envisage (mostly for micro loans) but in practice, securing a loan with a movable asset is rare.

The EBRD Secured Transactions Regional Survey, which was extended in 2005 to include Mongolia, advocates the need for considerable improvement in almost all aspects of secured transactions legislation regarding movables and intangibles (see Chart 4).

The current legal regime does not seem to provide the users with flexible and reliable means to take security. As a result, commercial lending is still troubled by high interest rates and by the under-developed institutional environment. The high borrowing cost and lack of long-term lending have been a problem for borrowers and especially for small and medium-sized enterprises (SMEs).

Outlook

The government has been proactive in addressing the challenges of attracting foreign investment by implementing structural economic reforms on the one hand and by continuing efforts to improve the quality of commercial laws on the other.

In that sense, it is remarkable that the bases of a legal framework allowing commercial activity and foreign investment have been laid relatively rapidly after the introduction of a market economy in the country. Considerable progress has been made over the last decade in reforming the commercial laws of Mongolia. The legal environment can be seen as favourable in some areas of foreign investment, such as mining, or even company law as far as the "law on the books" is concerned. Nevertheless the recent assessments conducted by the EBRD suggests that other sectors such as secured transactions, securities markets and insolvency law need further legislative and institutional reforms to reach acceptable international standards.

Notes

[1] At the time of going to press, 56 of the necessary 62 ratifications have been obtained.

[2] Legal developments that occurred after that date might not be taken into account in this article.

[3] See, for example, the European Union External Relations web site: http://www.eu.int/comm/external_relations/mongolia/intro/index.htm.

[4] GDP per capita in 2004 was around US$ 1,900.

[5] Article 27.1.

[6] See the OECD Principles of Corporate Governance 2004: http://www.oecd.org/dataoecd/32/18/31557724.pdf.

[7] Articles 153-185.

[8] Article 155.

[9] Article 153.

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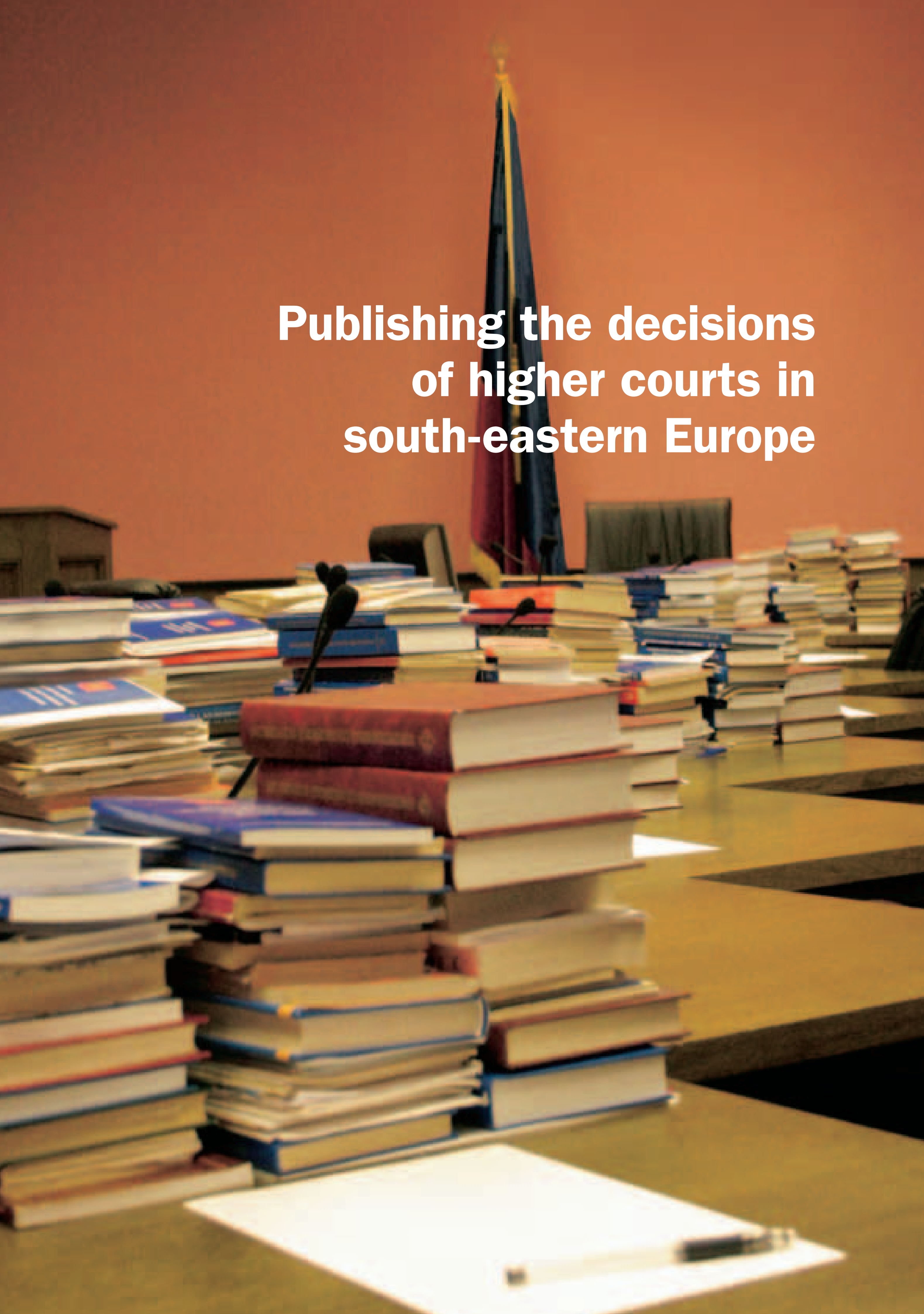
Publishing the decisions of higher courts in south-eastern Europe



Paul Byfield
Legal Information Specialist, EBRD

To foster confidence in a judicial system, court decisions should be published and accessible to the public. This article reviews the publication procedures of countries in south-eastern Europe and finds that much improvement is needed to bring them in line with international standards.

Judicial systems are expected to apply the law consistently and to render sound judgments. These decisions should be accessible to the wider public, enabling judgments to be evaluated and allowing comment on whether justice has been served. A link also exists between the transparency of a court system and the confidence this gives both the general public, and domestic and foreign investors.

The systematic publishing of judgments therefore demonstrates that the courts are willing to allow their decisions to be exposed to analysis by academics and the public. In particular, investors are keen to observe that their rights are being upheld in a court of law:

> *"Private investors and financiers will consider not only the potential for returns on investment in developing economies, but also whether investors' rights can be effectively enforced by the domestic legal system. Serious investors will also take into account whether property rights, contractual arrangements and other commercial activities will be free from arbitrary actions or interference by government, powerful individuals or special interest groups. A lack of confidence by investors and foreign businesses in the domestic legal regime of a developing economy translates into the withdrawal of investment and missed opportunities for improving living standards."*[1]

Systems should therefore be in place to publish judgments on request. This standard exists in some mature market economies, but the situation in south-eastern Europe[2] is less clear. This article analyses the results of two international surveys (undertaken since 2000) that related to or included the specific issue of publishing judgments in civil jurisdictions. The surveys analysed are the European Commission for the Efficiency of Justice (CEPEJ) Survey[3] and the judicial reform index prepared by the American Bar Association's Central and East European Law Initiative (CEELI).[4] The article also examines developments since the respective surveys, with a particular focus on the effects of EU accession negotiations.

The importance of a benchmark or international standard

It is important to have an international standard when assessing the performance of a country's legal framework. The existence of standards gives an indication of best practice, which in turn informs the assessor how much improvement needs to be made.

With specific reference to the transcription and publication of judgments and decisions, the Council of Europe has put forward a recommendation relating to this subject: Recommendation R (2001) 3 on the delivery of court and other legal services to the citizen through the use of new technologies.[5]

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This recommendation recognises the importance of modern technology in the system of justice. In both its preamble and main text, the recommendation establishes an important link between democracy and the ability of technology to improve democratic participation:

> *"… access of the citizens of Europe to laws, regulations and case law of their own and other European states and to administrative and judicial information should be facilitated through the use of modern information technology in the interest of democratic participation."*[6]

This recommendation gives an impetus to the court systems in the region to modernise and make their information more accessible to a wider audience. It also expresses, in Article 3, the means through which information should be disseminated:

> *"It should be as easy as possible to communicate with the courts and other legal organisations (registries, etc.) by means of new technologies.*
>
> *…[There should be] the possibility of having access to any information pertinent to the effective pursuance of the proceedings (statute law, case law and court procedures).*
>
> *The information should be disseminated using the most widely available technologies (currently the internet)."*

The appendix to the recommendation also sets out in very clear terms the categories of legal information which should be available:

> *"The term 'legal information' includes all official texts of laws, regulations and relevant international agreements binding on the state, together with important court decisions."*[7]

Some observers have stated that this section does not go far enough, citing all court decisions should be reported. Obviously this is quite an ambitious proposal considering the challenges that the countries of south-eastern Europe face in reforming their judicial systems.

However, it can be said that a more reasonable and therefore more achievable aim would be to publish in full text the cases that "really matter". This would include cases that either develop the law in some way or introduce or enhance a new point of law. This coverage would ensure that the system of having a legal system based on precedent, where it exists, is seen to be implemented and upheld.

The Council of Europe recommendation appears to be the only recognised international standard that relates specifically to the publication of court decisions. It could initially be assumed then that the international legal community does not regard this aspect of court administration important enough to justify any measures approaching standardisation. However, as this issue has been the subject of judicial assessments and surveys, objective judgments on how the relative judicial systems and the region is performing can still be made.

Current situation in some mature market economies

The systematic publishing of court decisions is a cornerstone of most common law jurisdictions. The history of court reporting in England and Wales is well recorded, with some of the earliest recorded cases dating back to the Norman conquest of England. The modern day environment for the publishing of court decisions in England was established in 1865, when the Incorporated Council of Law Reporting (ICLR) was set up for the:

> *"preparation and publication, in a convenient form, at a moderate price, and under gratuitous professional control, of The Law Reports of Judicial Decisions of the Superior and Appellate Courts in England."*[8]

The Australian court system is also very advanced in this area. The Supreme Court of New South Wales has published guidelines on the publishing of judgments in electronic form.[9]

In France, generally speaking, there is not a standardised system for reporting judicial decisions in print. The government portal site links to various official court web sites, which vary in their coverage of court decisions. There are also very selective, important decisions available online for free from the official court web sites. A much larger database of judgments is available from fee-based commercial online services. The *Cour de cassation, Conseil d'Etat, Tribunal des conflits* and *Conseil constitutionnel* decisions are available in full text online (www.jurifrance.com and www.lamyline.com). Selected Court of Appeal decisions from 1980 onwards are available from Jurisdata (www.jurisdata.com). The most frequently used collections of reports are the well-indexed legal reviews, which contain a large selection of decisions from civil, criminal and administrative courts.

In Germany legal journals are usually very advanced at publishing court decisions. Some have specialised almost entirely in the publication of cases from both regional and appellate courts, many in electronic format (for example, *NJW-Rechtsprechungs-Report, NZA-Rechtsprechungs-Report* and *NVWZ-Rechtsprechungs-Report*). Aside from quasi-official compilations, there are various commercial publications of court decisions, both federal and state.

Most of these are in looseleaf format, with some available electronically, and focus on specific fields of law.

There are currently numerous initiatives by commercial publishers to set up databases of court decisions (accessible via the internet). These will either be based on existing print versions or developed with other providers. This publishing market is set to undergo fundamental changes over the next few years.

South-eastern Europe

The CEPEJ Survey was conducted in 2002 in 40 member states of the Council of Europe, including the six Balkan countries. The aim of the survey was to measure and ensure the implementation of European legal standards and to improve the quality and efficiency of judicial systems. The survey was conducted as a self report (that is, questionnaires were sent out to selected respondents in each country and they in turn provided answers to the 108 questions contained in the survey).

The survey, despite its breadth, is recognised as having certain shortcomings. In fact, the Commission in its report "European judicial systems 2002 – Facts and figures on the basis of a survey conducted in 40 Council of Europe member states" says the following:

> *"This report, which is the conclusion of a pilot exercise, obviously contains limits and shortcomings because of its experimental character. At this stage, we have chosen not to address the whole set of data collected, taking into account the existing difficulties for comparing judicial systems which are both complex and diverse. … To that extent, this report is a forerunner of what could very well become a regular exercise carried out by the CEPEJ to evaluate the European judicial systems."*[10]

The survey, however, remains the most extensive of its type conducted to date. It can be relied upon as a good indication of the state of the judicial systems and more specifically the publication of court decisions in the region.

One of the survey questions asked whether official internet sites/portals (for example, the Ministry of Justice) were available through which the general public have free access to the case law of higher courts. The results are shown in Table 1.

Of the six countries questioned, only one country – Serbia and Montenegro (Serbia only) – did not provide public access to case law. (There were no data available for Bosnia and Herzegovina.)

The survey's question format was very straightforward with respondents only required to give a yes or no answer. This type of approach often minimises the possibility of confusion or ambiguity.

These results focus on the availability of a web site or portal through which the general public can access case law. It does not consider, however, whether the official gazette (or another related publication) is readily available in public libraries or other public buildings. Therefore, the results are neither comprehensive nor conclusive, but they do give a good indication of the availability of court decisions online.

Another factor that is relevant to the publication of court decisions (apart from the will or perceived necessity of the relevant legal body to publish them) is cost. The CEPEJ Survey looked at the public expenditure of the member countries on the courts and legal aid per inhabitant. Using the United Kingdom as an example (ranked fourth in the world for public expenditure), it demonstrates that there can be a link between budget levels and the publication of court decisions.

Table 1 Results of the European Commission for the Efficiency of Justice (CEPEJ) Survey – Access to published case law

Country	Public access	Source of published case law
Albania	■	Supreme Court of Albania www.gjykataelarte.gov.al
Bosnia and Herzegovina	na	–
Bulgaria	■	Constitutional Court www.constcourt.bg Supreme Administrative Court www.sac.government.bg Supreme Judicial Council www.vss.justice.bg
FYR Macedonia	■	Official gazette www.slvesnik.com.mk
Romania	■	Ministry of Justice www.just.ro/
Serbia and Montenegro (Serbia only)	■	–

■ No ■ Yes na = no data available

Source: CEPEJ Survey 2002.

The four countries in the region which responded to this part of the questionnaire spend far less on the court system per head than most western European countries (see Table 2). It can therefore follow that where resources are scarce, those resources may be allocated elsewhere and not used to publish court decisions, whether in hard copy or via online services.

The CEELI judicial reform index

The CEELI judicial reform index (JRI) has been conducted in all the countries of south-eastern Europe since 2001. The index comprises 34 determining factors that give an indication of the state of judicial reform in each country. The factors establish a standard by which a country's performance can be assessed. A rating is given for each factor and an explanation of the findings is also provided.

For the purposes of this article, only one of the factors needs to be considered: the publication of judicial decisions. The JRI states that judicial decisions are generally a matter of public record, and significant appellate opinions should be published and open to academic and public scrutiny.

Each factor in the JRI is given a rating of either negative, neutral or positive. These indicate the relationship of the country's judicial system to that factor. For example, if a country's judicial decisions are not a matter of public record then it would achieve a negative rating.

All of the countries in south-eastern Europe scored a negative rating for the publication of judicial decisions, with the exceptions of FYR Macedonia and Romania, which both were neutral.

Country analysis

An in-depth analysis of each country's judicial system, citing relevant legislation and common practice where applicable, was also conducted. The results of this analysis are detailed below (see also Table 3).

Albania

In Albania, Article 132 (2) of the 1998 Constitution enacts into law the duty of the Constitutional Court as follows:

> *"The decisions of the Constitutional Court enter in force on the day of their publication in the official gazette. The Constitutional Court can decide that the law or normative act is to be invalidated on another date. The minority opinions are published together with the decision."*[11]

Article 146 (2) of the Constitution also addresses the matter concerning other courts:

> *"In every case judicial decisions are announced publicly."*[12]

The negative rating achieved by Albania in the JRI, however, suggests that common practice does not follow the wording of the constitution. The decision to allow access to court decisions is often made by the relevant court president. This often leads to *ad hoc* decision making rather than any uniform standard. As a potential EU candidate country with aspirations of joining within the next 10 years (2010-15), Albania is faced with many challenges, not least with regard to its judicial system.

Bosnia and Herzegovina

According to the results of the JRI, Bosnia and Herzegovina received a negative rating for the publication of judicial decisions. Decisions are rarely published and not readily available. However, closer analysis shows that some higher courts do publish court decisions, for example constitutional decisions are published in the relevant official gazettes.

Article VI, section 2 (b), of the Constitution states:

> *"The (Constitutional) Court shall adopt its own rules of court by a majority of all members. It shall hold public proceedings and shall issue reasons for its decisions, which shall be published."*[13]

As the constitution is silent on the subject of the frequency of publication, it is difficult to interpret what this means in practice. There are, however, noted time delays in the publication of court decisions but this appears to be a matter of implementation.

Article 105 (2) of the rules of the Constitutional Court has established a permanent Publications and Information Committee. Furthermore, the Supreme Courts at the federal level and in Republika Srpska only publish commentaries of the decisions and not the actual text. This approach appears to be fairly indicative of the attitude towards the publication of court decisions at the present time.

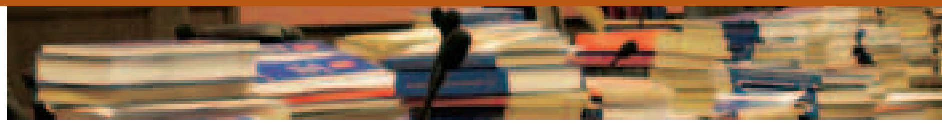
USAID are providing support to a commercial court reform project. This project will without doubt have an impact on the publication of court decisions. Unfortunately, the 2005 EU Progress Report has not addressed this issue.

Table 2 Court budget per inhabitant

Country	Court budget per inhabitant (in €)
Switzerland	109.60
United Kingdom	70.69
Germany	56.02
FYR Macedonia	6.95
Romania	5.40
Bulgaria	3.53

Source: CEPEJ Survey 2002.

The judicial reform index has been conducted by the American Bar Association's Central and East European Law Initiative (CEELI) in all the countries of south-eastern Europe since 2001. One of the factors considered is the publication of judicial decisions.



Bulgaria

The publication of court decisions in Bulgaria is largely regulated by Article 212 of the Code of Civil Procedure.

The information available, however, suggests a rather more ad hoc approach. Whilst Higher Appellate Court decisions can be published, it is often at the discretion of the judge as to whether it will be made public. The Bulgarian Constitutional Court has published decisions on its web site[14] since 1994, however, these are summaries rather than the full text.

The Bulgarian judicial system is in the fourth year of a reform strategy. To date, several key reforms have already been implemented: a judicial training programme, a range of ethical codes and the Penal Procedure Code (adopted October 2005). A backlog of cases, however, still remains and there are considerable delays in the enforcement and publication of judgments. On a positive note, there have been some notable successful initiatives at the local level. For example, the Varna district court has recently started publishing decisions of commercial disputes online.

FYR Macedonia

FYR Macedonia improved its rating in the most recent JRI (published in 2003). The report concluded that although most judicial decisions are unpublished, interested parties, including academics, are able to request access. The constitutional court also publishes copies of decisions in the official gazette.

Article 83 of the Constitutional Court Procedures requires the court to make information available to the public. The court publishes a bulletin and a permanent collection of decisions as resources for the public. The Public Policy of the Constitutional Court also contains some guidelines on publishing court decisions; mainly that the court publishes a Year Book of decisions.

As an EU candidate country, FYR Macedonia has already begun to implement various legislative improvements to strengthen legal procedures. The EU Progress Report, published in November 2005, noted that a new law on civil procedure (adopted in September 2005) should make the court system more efficient.

However, even though candidate status has been granted, the report did note that foreign direct investment (FDI) has been low in recent years. It went on to confirm that one direct cause of this related to legal uncertainty. Investors are unsure of their rights and duties within the country's legal framework.

International agencies have been working in the country to improve this situation. In 2003 a court modernisation project was initiated, jointly sponsored by USAID and DPK Consulting.

Romania

The 2002 JRI noted that the publication of court decisions in Romania was uneven and the coverage of judicial affairs by the mainstream press poorly informed.[15]

Constitutional decisions (from 1992-present) are published on the web site of the Constitutional Court. These are also published in a variety of mediums and available to a relatively wide audience (professional, academic and the general public). The EU Comprehensive Monitoring Report for Romania (October 2005) noted that the government adopted certain laws relating to judicial reform in June 2005 and this momentum is vital to any improvements in the Romanian judicial system.

The Supreme Court's decisions are consciously followed by lower courts' judges in an effort to unify the law of the land. At present, however, there is no system for publishing judicial decisions, similar to that of the United Kingdom. There are specialised collections of decisions, heavily edited and hand selected by academic authors, that contain summaries of legal decisions in civil law matters.

It should be noted that the Romanian Minister of Justice has created an electronic database, which contains summaries of post-1989 decisions, issued by the Supreme Court of Romania and some Courts of Appeal. The summaries are in Romanian and searches may be done by typing words contained in the text of the summary, such as "land" or "agriculture".

Romania is heading towards EU membership in 2007. As a result, the process of reform is well under way. In June 2005 the World Bank approved a loan for the implementation of a four and a half year judicial reform project. The aim of this project is to increase the efficiency and transparency of the courts and to minimise corruption in the judiciary and other legal officers.

Table 3 Publication of court decisions in south-eastern Europe

Country	Constitutional Court	Supreme Court
Albania	Court decisions not published	Court decisions published
Bosnia and Herzegovina	Published electronically	Court decisions published
Bulgaria	Published electronically	Court decisions published
FYR Macedonia	Published electronically	Court decisions published
Romania	Published electronically	Court decisions published
Serbia and Montenegro (federal system)	Published electronically	na
Serbia and Montenegro (Serbia)	Court decisions not published	Court decisions published
Serbia and Montenegro (Montenegro)	Published electronically	Court decisions published
Serbia and Montenegro (Kosovo)	na	Court decisions published

■ Court decisions published ■ Published electronically ■ Court decisions not published
na = no data available

Notes: Table 3 illustrates the availability of court decisions to those who are not parties to a case (for example, academics and members of the public). The countries vary in the scope of decisions available from different court levels, and their accessibility via the internet. The overriding theme is that more needs to be done to make important court decisions universally available.

Source: EBRD.

Serbia and Montenegro[16]

Serbia

The JRI report in February 2002 concluded that only the Supreme Court and two district courts in Serbia actually produce regular bulletins. In addition, these bulletins only cover certain decisions. A later JRI update (published in 2003) did not consider this factor.

Article 30 of the law on the organisation of courts (2002) appears to confirm the earlier position:

> *"The decisions of the Supreme Court of Serbia relevant for case law and all general legal principles shall be published in a special collection."*[17]

Commercial court decisions are available on the web site of a commercial publisher for an individual fee or by subscription.[18] This limits availability for academics and members of the public.

The Serbian government adopted a judicial reform strategy in April 2004. The Commission for Judicial Reform was given the task of amending or adopting 41 pieces of legislation with the strategic goal of improving the quality of judicial practice to a level that corresponds with a modern market economy.[19]

Montenegro

The court system in Montenegro, a constituent republic of Serbia and Montenegro, is supervised by the Ministry of Justice. The 2002 JRI indicated that court decisions are not published and that copies of decisions can only be accessed by interested parties.

Current practice does show a slightly more positive situation. The Constitutional Court is publishing its decisions in the official gazette, while the Supreme Court is publishing selected summaries. The current EU Progress Report for Serbia and Montenegro, however, is silent on this.

USAID has initiated a three-year judicial reform project in conjunction with the Supreme Court of Montenegro. The programme, which began in 2003, has many objectives including the increase of efficiency and transparency:

> *"... the project will address methods of strengthening court operations, caseload management, and public access to services and information, which ultimately, will minimise the time necessary to resolve cases and increase public understanding of the judicial process."*[20]

Kosovo

Kosovo is administered by the United Nations Mission in Kosovo (UNMIK). This body has been gradually transferring its powers to local bodies, including the administration of the courts. At the time of the JRI update in 2004 copies of court decisions were only available by request from court officials to those who could demonstrate a "justifiable interest".

Since that time the Kosovo Law Centre, with support from international donors, has started publishing excerpts of Supreme Court decisions. The National Centre for State Courts has also been conducting a judicial reform project which, amongst other tasks, is establishing a programme to publish relevant case law and other legal texts.

The Supreme Court of Kosovo Bulletin of Case Law is published periodically, and contains excerpts and full text of selected Supreme Court judgments. The aim of the bulletin is to ensure transparency in the work of the Supreme Court and to help foster the development of case law in Kosovo.

The bulletin contains a collection of the most interesting verdicts and decisions of the Supreme Court of Kosovo on criminal, civil, commercial and administrative cases. The first volume contains cases from 1999-2002 and the second volume covers 2002-03.

As can be seen, the situation is improving but access to judicial decisions by the public and academics will not be possible until suitable resources and administration have been fully implemented.

Conclusion

Most of the constitutional courts in the region with the exceptions of Albania and Serbia and Montenegro (Serbia), have only a summary of their decisions freely available on their court web sites. The publication of Supreme Court and other appellate level decisions varies across the region. When looking at south-eastern Europe as a whole, it can generally be said that there is some publication of summaries of court decisions in higher courts and very little in the middle tier or lower ranking courts, especially in the commercial sector. This can be perceived as detrimental to the economic environment in the region as investors will lose confidence in a less than transparent judicial system.

The countries of the region are all at different stages of the EU accession process. The impact of that negotiation process should not be underestimated. The *acquis communautaire* requires all candidate countries to adopt new laws and reform measures before accession. However, the recent EU progress and monitoring reports all point to quite severe weaknesses in the judicial systems. (Lack of judicial independence, poor maintenance of court buildings and severe backlogs of court cases are all major themes).

With these apparent fundamental problems, it may be difficult to persuade the relevant bodies that the publication of court decisions should be treated as a priority. These countries, whilst they will not immediately reach international standards of best practice may, when they have achieved EU accession, see some improvement in access to court decisions. This will occur firstly by court staff and other professional parties, and invariably extend to members of the public.

More positively, however, there is extensive assistance from international agencies and donors within the region. This has and will continue to have a positive effect on the judicial systems of the region, combined with the reform efforts of the respective government agencies.

This process will inevitably lead to greater investor and public confidence in the legal systems, whilst hopefully enabling them to retain their own specific legal culture. It will therefore be interesting to see what improvements will have been made when the next CEPEJ and CEELI surveys are published.

Notes

1 European Agency for Reconstruction, "In the dock: justice in the Balkans", July 2003.

2 South-eastern Europe refers to: Albania, Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Romania, Serbia and Montenegro.

3 http://www.coe.int/T/E/Legal_Affairs/Legal_co-operation/Operation_of_justice/Efficiency_of_justice/

4 http://www.abanet.org/ceeli/publications/jri/

5 http://cm.coe.int/ta/rec/2001/2001r3.htm

6 http://www.coe.int/T/E/Legal_Affairs/Legal_co-operation/Operation_of_justice/Information_technology/Documents/2_Recommend_CJ_IT_ENG.asp#TopOfPage

7 http://www.coe.int/T/E/Legal_Affairs/Legal_co-operation/Operation_of_justice/Information_technology/Documents/2_Recommend_CJ_IT_ENG.asp#TopOfPage

8 Memorandum and Articles of Association, 1870.

9 http://www.lawlink.nsw.gov.au/lawlink/supreme_court/ll_sc.nsf/pages/SCO_elecformjudg

10 http://www.coe.int/T/E/Legal_Affairs/Legal_co-operation/Operation_of_justice/Efficiency_of_justice/systeme%20judiciaire%20A.pdf

11 http://www.parlament.al/english/dis-kus/dis-kus.html

12 http://www.parlament.al/english/dis-kus/dis-kus.html

13 http://www.ccbh.ba/Default.aspx?lang=en&page=texts/constitution/preamble

14 http://www.constcourt.bg/constcourt/ks_eng_frame.htm

15 http://www.abanet.org/ceeli/publications/jri/home.html

16 For the purposes of this article Serbia, Montenegro and Kosovo are discussed as separate legal entities.

17 http://spai-rslo.org/documents/serbia/legislation/organisation_courts.pdf

18 http://www.intermex.co.yu/english/index.htm

19 http://www.judicialreform.sr.gov.yu/

20 USAID project press release, 15 October 2003.

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Focus section: Implementing corporate governance frameworks

Sound corporate practices are essential for attracting investment. The OECD Principles of Corporate Governance often serve as a benchmark for defining corporate legislation and for protecting the rights of investors. Several transition countries have developed legislation in compliance with the Principles, but this legislation is only effective in a few countries.

This issue of *Law in transition* focuses on the importance of implementing sound corporate governance frameworks and describes some of the recent actions undertaken by policy makers within the EBRD region.

The first article, by Gian Piero Cigna of the EBRD and Luca Enriques of the University of Bologna, presents the main results of the Bank's 2005 Legal Indicator Survey. The survey assessed the effectiveness of legislation in providing minority shareholders with disclosure and redress – two keys aspects of corporate governance. The article highlights areas where reform is needed. The Bank's commitment to strengthening corporate governance in its investee companies is examined in an article by EBRD Deputy General Counsel, Norbert Seiler.

The following four articles are dedicated to corporate governance codes. Eddy Wymeersch, a contributor to the debate on corporate governance in Europe and an actor in the development of the revised OECD Principles, analyses how codes are implemented and enforced in the newly enlarged European Union. Wiesław Rozłucki and Anna Miernicka-Szulc of the Warsaw Stock Exchange discuss Poland's efforts to enhance corporate governance in listed companies. Julia Kochetygova and Oleg Shvyrkov of Standard & Poor's analyse the state of corporate governance in Russia, which benefited from EBRD assistance in developing its corporate governance code. Stella Muntean of the Moldovan National Securities Commission provides a commentary on the Moldovan legal framework and recent efforts to adopt a corporate governance code.

The next article, by Alexei Zverev of the EBRD, details the new CIS Model Law on the Protection of Investor Rights in Securities Markets. This model law was sponsored by the EBRD and was recently approved by the Inter-parliamentary Assembly of the Commonwealth of Independent States. In the final article, Arthur Stepanyan and Ashot Petrosyan highlight a new initiative by the Central Bank of Armenia to raise the quality of financial disclosure in the country.

Assessing the effectiveness of corporate governance legislation: disclosure and redress in related-party transactions

Gian Piero Cigna
Counsel, EBRD

Luca Enriques
Professor, University of Bologna and Consultant to the EBRD

In 2005 the EBRD's Legal Indicator Survey assessed the effectiveness of corporate governance legislation in transition countries. In particular, the survey sought to ascertain how well minority shareholders in both unlisted and listed companies would fare in a typical conflict of interest situation.

Effective corporate governance mechanisms protect the interests of investors and other stakeholders in business ventures. These mechanisms are key to a country's financial and economic development. A precondition for the development of capital markets is that outside investors can expect insiders (managers and more often controlling shareholders) not to divert corporate assets to themselves. The law and its enforcement institutions play an important role in preventing insiders' opportunism and, hence, in strengthening investors' expectations.

Extensiveness: the assessment

In 2004 the EBRD assessed corporate governance legislation in the Bank's region.[1] It enquired into whether and to what extent corporate governance legislation (the "laws on the books") in each of the Bank's countries of operations complied with the OECD Principles of Corporate Governance. The assessment reported a considerable variation in standards.

Nine countries were given "high" compliance ratings, indicating a sound legal framework in line with the OECD principles. Ten countries had "medium" compliance, meaning their legal framework was generally in line with international standards despite a number of shortcomings. Four countries received "low" compliance ratings, implying serious shortcomings in their legislation when compared with international standards.

Effectiveness: the Legal Indicator Survey

The EBRD Legal Indicator Survey (LIS) conducted in 2005 focused on the effectiveness of corporate governance in the Bank's countries of operations.[2] Instead of looking at the laws on the books, it aimed to assess how well the laws work in practice. To achieve this, the survey took the perspective of a minority shareholder trying to find out whether the controlling shareholder had abused its power. The survey also looked at how a minority shareholder could obtain redress.

A hypothetical case study was developed to ascertain how well minority shareholders of both an unlisted and a listed corporation would fare in the context of a typical conflict of interest situation. In particular, it dealt with a controlling shareholder entering into a sale contract with the corporation. The LIS therefore covered self-dealing, which is widely held to be "*the* central problem of corporate governance in most countries".[3] In total, the survey assessed 26 EBRD countries of operations as well as Mongolia.[4]

Methodology

The methodology employed followed on from previous surveys.[5] Accordingly, it involved working with leading law firms in the region.[6] These law firms were provided with two broadly similar hypothetical case studies involving a related-party transaction (see Box 1).

In the first case study Alfa Ltd is an unlisted company controlled by Beta Ltd. Beta Ltd owns 76 per cent of the company's shares, while the remaining 24 per cent is owned by minority shareholder Gamma Ltd. In the second case study Alfa Ltd is a listed company, with Beta Ltd owning a 56 per cent controlling stake, Gamma Ltd owning a 12 per cent minority stake and 32 per cent of the capital floating on the

Box 1 A related-party transaction scenario

Joint-stock company Alpha Ltd is a leading firm in a transition country. Its registered headquarters is located in the main business centre within that country. Alpha is co-owned by two companies, Beta Ltd and Gamma Ltd.

Beta Ltd is the controlling shareholder. Its owner is an influential business leader, who also controls another company, Beta Holding Ltd, one of the main conglomerates in the country. Gamma Ltd is an investment company set up by a foreign investor. It owns a minority stake in Alpha Ltd. Alpha's board of directors is composed of three members, all appointed by Beta Ltd. Two of them also sit on Beta Holding's board.

Following an anonymous tip-off from an employee, Gamma has reason to believe that Alpha's directors have sold Alpha's property to a subsidiary of Beta Holding Ltd for 50 per cent less than its true worth.

According to the company's charter, such a transaction – that is, where a director has directly or indirectly a conflicting interest and which exceeds a given value – must be approved by the shareholders' meeting.

Gamma asks for legal advice on what can be done to:

- determine whether the transaction has indeed been entered into
- restore the status quo (by, for example, challenging the validity of the transaction)
- obtain damages for Alpha
- obtain damages for Gamma
- punish Alpha's directors and the majority shareholder (through, for example, criminal sanctions or disgorgement of profits).

stock exchange.[7] In both cases, the damage suffered by Alfa Ltd from the transaction was valued at €2 million.

In the case study scenarios the minority shareholder is faced with two problems:

- It has to determine whether the transaction was entered into and on what terms.
- It has to obtain some form of redress through a private action in court or otherwise.

An extensive questionnaire was designed to establish how effective each country's legal system is in protecting a minority shareholder's interests.[8] Law firms were asked to respond to the questionnaire as if they were advising the minority shareholder on how best to protect their rights and preserve the value of their financial investment in the local company. The questionnaire focused on three main areas:

- the mechanisms by which the minority shareholder can find out whether the transaction had been entered into (disclosure)
- the tools for redress
- the institutional environment in which such disclosure and redress tools have to be used.

Respondents were asked to provide information on the legal tools available for disclosure and redress and to assess their effectiveness in terms of speed, simplicity and enforceability (see Chart 1). Concerning the institutional environment, they were asked to assess a number of institutional features affecting the enforcement of corporate governance law provisions and standards (see Chart 2). These included the competence of courts and financial market regulators, the availability of previous case law and the presence of arbitration bodies specialising in business law.

The variables

Measuring the effectiveness of a legal mechanism is a complex process. Several variables should be taken into account and most of them involve subjective judgements by respondents. Speed, simplicity, enforceability and the institutional environment have been used as measures for the effectiveness of disclosure and redress mechanisms.

Speed

Speed is the most straightforward factor. In disclosure cases, it refers to the average time between the initial filing of proceedings with the court and the issuance of an executable court order, taking into consideration an appeal by the defendant. In redress cases, it concerns the period from the initial filing of the proceeding to the issue of a court's executable judgement, again taking into consideration an appeal by the defendant.

Simplicity

Simplicity relates to the smoothness of proceedings. More precisely, respondents were asked to assess how clear, simple and straightforward the proceedings relating to the available actions were. The guidance offered by judicial precedents in interpreting the law was also considered here, as it simplifies law enforcement by increasing legal certainty.

Enforceability

Enforceability relates to the carrying out of the executable judgement in cases where the other party fails to implement it, and extends far beyond corporate governance. Respondents were asked to assess the ease of enforcing a judgement in favour of the minority shareholder.

Measuring the effectiveness of a legal mechanism is a complex process. In the Legal Indicator Survey, speed, simplicity, enforceability and the institutional environment were used to measure the effectiveness of disclosure and redress mechanisms.

Institutional environment

The institutional environment relates to the capacity of a given legal framework to provide the basic guarantees that are needed for legislation to be effectively implemented and enforced. It includes a number of factors regarding disclosure and redress:

- the perceived reliability of a company's books
- the requirement to have corporate financial information audited
- the presence of international auditing firms in the country[9]
- the perceived independence of statutory auditors
- the perceived degree of competence and experience of courts and prosecutors
- the availability of up-to-date legislation
- the ease with which the defendant can delay the proceedings
- the perceived influence that might be exercised on courts and prosecutors by a powerful defendant.

With regard to both disclosure and redress Transparency International's Corruption Perception Index 2005 was also taken into account.[10]

Results

The findings of the survey are necessarily limited and must be treated with caution. First, they reflect the views of a limited number of practitioners within each country.[11] Secondly, they address a very specific set of circumstances and must be considered within the boundaries of the case studies. Thirdly, assessing effectiveness is by necessity far more difficult and subjective than finding out what the laws on the books state in a given country. It deals with hard to measure variables such as courts' competence, simplicity of procedures, ease of enforcement and so on.

Detecting wrongdoing by a dominant shareholder

The first part of the analysis focused on how a minority shareholder might discover if the company's management had indeed entered into a related-party transaction. The assumption here was that the majority shareholder controls the board and that no disclosure of the transaction was spontaneously provided to the minority shareholder.

Disclosure is one of the key pillars of an effective corporate governance framework.[12] In the context of related-party transactions, disclosure is usually analysed in terms of an obligation to inform the board and/or shareholders and/or the public about such transactions.[13] Since the LIS focused on the effectiveness of the legal framework for corporate governance as opposed to its extensiveness, the case studies assumed that, whatever the disclosure obligations in place, no disclosure had been given on the transaction to the relevant bodies. This, of course, is often the case when assets are siphoned off a company by its dominant shareholder.

Consequently, the questionnaire focused on the tools available to minority shareholders who suspect a self-dealing transaction has been entered into. It also centred on the efficiency of the tools in terms of speed, simplicity and enforceability. In addition, the questionnaire asked respondents what the probability of successfully detecting wrongdoing by using these tools was.

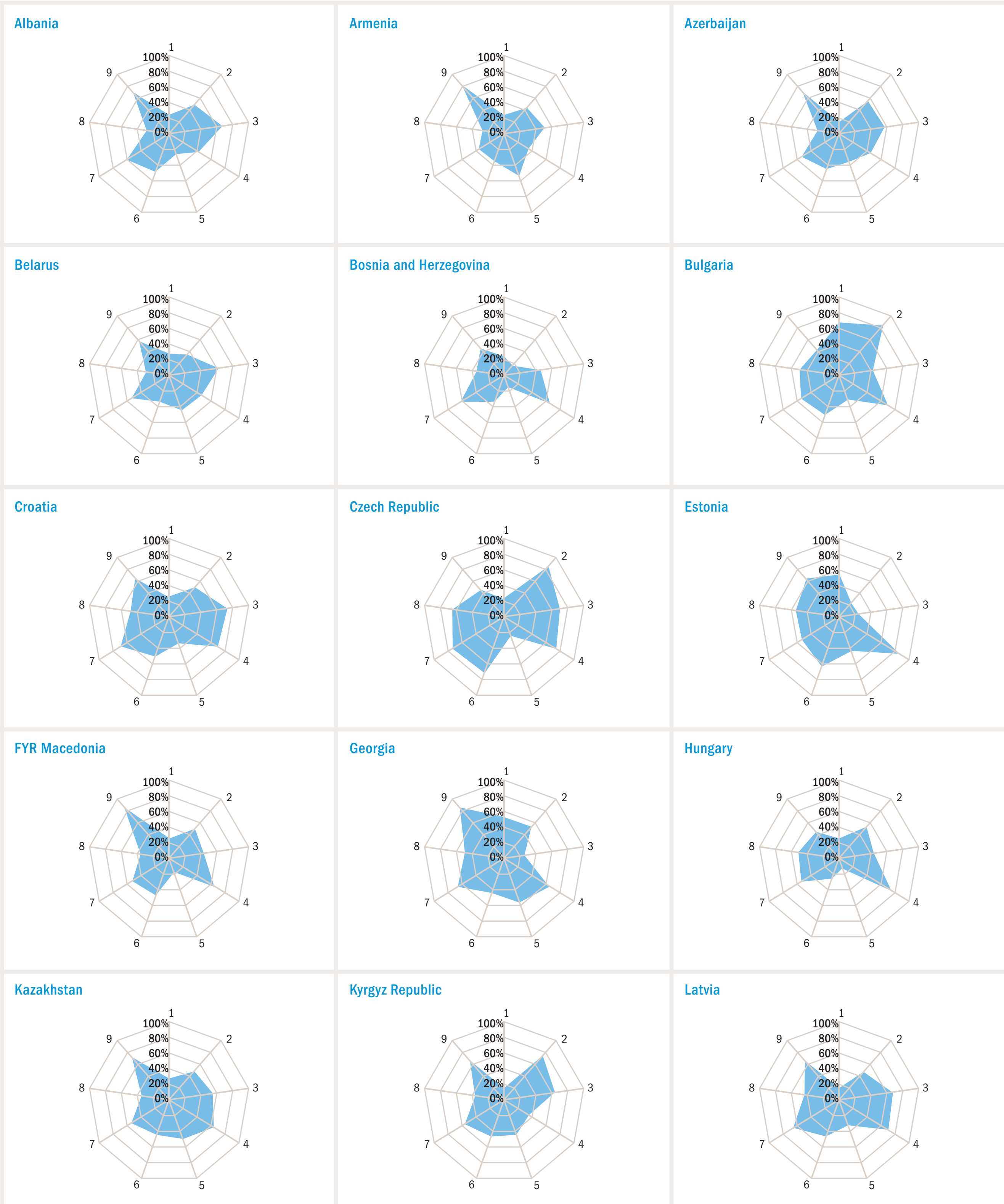
The questionnaire listed six legal tools that could help a minority shareholder discover whether a self-dealing transaction has been entered:

- inspecting the company's books and other corporate documents
- requesting information from the company's auditor
- demanding an independent audit
- asking the court to appoint an independent auditor
- requesting the court or another public body to have an administrator appointed
- calling a special shareholders' meeting to question the company's management.

Respondents were free to add other actions the minority shareholder could take.

As the LIS revealed, only a few countries offer an institutional framework providing minority shareholders with effective mechanisms to obtain disclosure. In many countries minority shareholders face substantial problems and their actions can be easily blocked by majority shareholders.

Chart 1 Effectiveness of corporate governance legislation in the case study scenarios

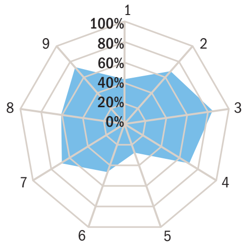


Notes: The graphs show disclosure, redress and the institutional environment in the transition countries. The average results from the case study scenarios are shown. Disclosure refers to a minority shareholder's ability to obtain information about their company. Redress refers to the remedies available to a minority shareholder whose rights have been breached. Institutional environment refers to the capacity of a country's legal framework to effectively implement and enforce corporate governance legislation. Costs refer to the estimated expenses a minority shareholder must pay to take legal action.

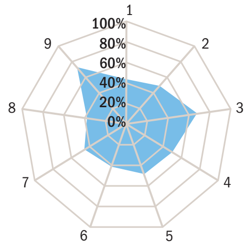
The extremity of each axis represents an ideal score: the fuller the 'web', the better the corporate governance framework. Data was collected for 26 of the EBRD's countries of operations and Mongolia. Data for disclosure in Serbia and Montenegro (Kosovo) and redress in Tajikistan were not available for the second case study. In both instances, there was no effective action available for minority shareholders to take.

Source: EBRD Legal Indicator Survey 2005.

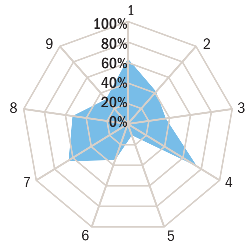
Lithuania



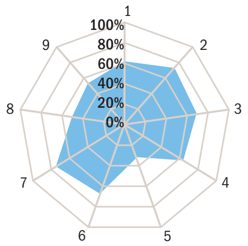
Moldova



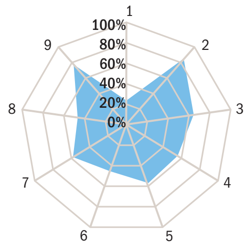
Poland



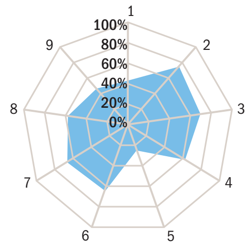
Romania



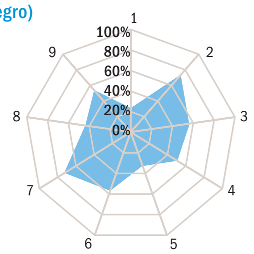
Russia



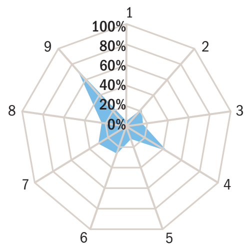
Serbia and Montenegro (Serbia)



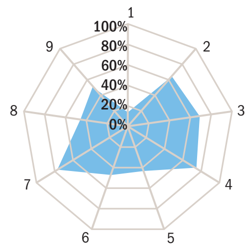
Serbia and Montenegro (Montenegro)



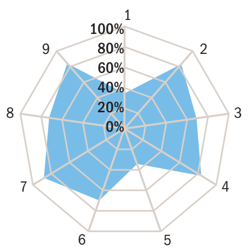
Serbia and Montenegro (Kosovo)



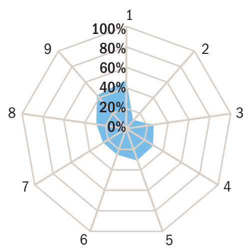
Slovak Republic



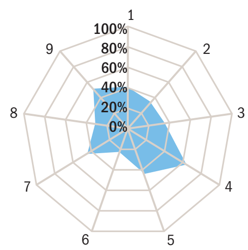
Slovenia



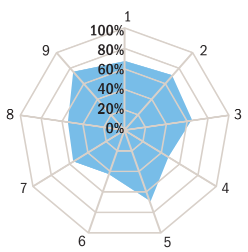
Tajikistan



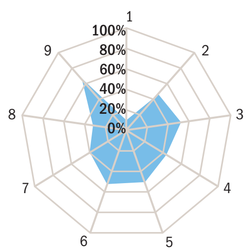
Ukraine



Uzbekistan

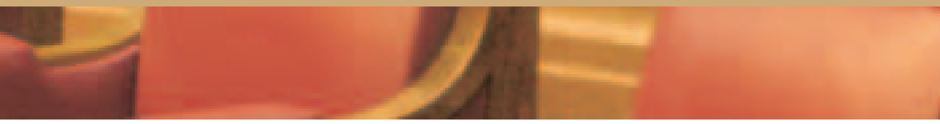


Mongolia



1 Speed of disclosure proceedings
2 Simplicity of disclosure proceedings
3 Enforceability of disclosure rulings
4 Institutional environment relating to disclosure
5 Speed of redress mechanisms
6 Simplicity of redress proceedings
7 Enforceability of redress rulings
8 Institutional environment relating to redress
9 Costs

Only a few transition countries offer an institutional framework which provides minority shareholders with effective mechanisms to obtain disclosure. In many countries minority shareholders face substantial problems and their actions can be easily blocked by majority shareholders.



Central Europe and the Baltic states

The survey showed that within CEB a reasonable level of effectiveness regarding disclosure can be found in the Czech Republic, Lithuania and Slovenia. Problems have been identified in Estonia and Poland.

Local practitioners reported that procedures are particularly complex in Estonia but generally clear and simple in the Czech Republic and Slovenia. The estimated time needed to obtain a court order varies from a few months in Poland to two or more years in the Czech Republic and the Slovak Republic. While enforceability might be difficult in Estonia, it is considered particularly straightforward in Lithuania and Slovenia. Lastly, the institutional environment is deemed generally sound in all countries, although Latvia displays some weaknesses.

In Slovenia a number of actions are available to minority shareholders. Clear procedures and smooth enforceability are complemented by a sound institutional environment. Courts are considered generally competent and company books are regarded as reliable. Only the time needed to obtain an executable court order (more than one year) appears to be unsatisfactory.

In the Czech Republic the institutional environment is deemed to be sound and procedures are considered clear and simple. Enforceability is generally efficient but can vary substantially depending on the type of action pursued. Only the time needed to conclude proceedings, which can exceed three years, is perceived as a problem.

In Estonia shareholders with a 24 per cent stake in a joint-stock company can request a general shareholders' meeting.[14] This, however, is the only course of action available and the law provides for no enforcement mechanism in cases where management does not implement the shareholders' request. As a result, minority shareholders can only rely on the annual financial documentation presented at the general meeting. Although such documentation is generally considered of good quality, shareholders will have no other means of further investigation should they suspect that the information is incomplete or incorrect.

When looking at the unlisted company case study scenario, Poland demonstrates a similar situation although a minority shareholder with a 24 per cent stake has, by virtue of law, the right to nominate a representative to the supervisory board.[15] It is doubtful, however, whether the minority shareholder will gain access to information gathered by the supervisory board member as they have confidentiality and fiduciary duties to the company. In practice, however, this mechanism allows greater control over a company's operations and might discourage abusive behaviour by controlling shareholders.

South-eastern Europe

Within SEE a relatively effective framework for disclosure was reported in Romania and Serbia. The average time needed to obtain a court order varies from a few months in Bulgaria and Romania to three or more years in Bosnia and Herzegovina and Kosovo, where procedures are also deemed to be complex and difficult to enforce. The institutional environment is considered especially weak in Albania and Kosovo, but relatively sound in Romania.

In Bosnia and Herzegovina several courses of action are open to a minority shareholder but none have realistic prospects of enforcement should the controlling shareholder refuse to cooperate.

In Kosovo minority shareholders can only request a general shareholder meeting, but this is likely to be ineffective if the controlling shareholder is hostile. Moreover the legal framework is very complex, being a mix of United Nation Interim Administration Mission in Kosovo (UNMIK) regulations and old Yugoslavian law.[16] While UNMIK regulations dealing with corporate governance are limited,[17] there is reluctance on the part of local judges to apply the old Yugoslavian law, which leads to lower legal certainty.

In Albania the average time needed to get a court order is about six to eight months, although a defendant has several means of delaying the procedure. Procedures are not considered particularly complex or difficult to enforce. However, the institutional environment is weak. Company books are considered generally unreliable, statutory auditors are usually unable to act independently and courts are inexperienced in corporate cases.

Commonwealth of Independent States

All CIS countries display substantial shortcomings in the legal framework for disclosure. Procedures are deemed very long in Azerbaijan, the Kyrgyz Republic and especially complex in Tajikistan. Enforceability is considered a problem in Georgia, Tajikistan and Ukraine, and the institutional environment is particularly poor in Armenia and Tajikistan.

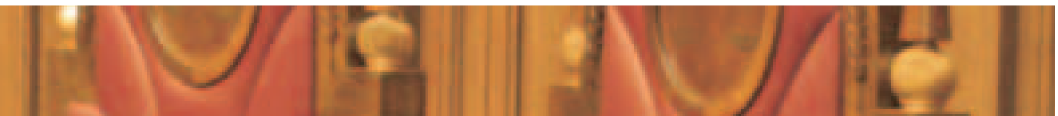
Tajikistan appears to have the least effective legislation. There are no specific law enforcement proceedings, and court executors do not have the necessary enforcement authority, particularly against a powerful defendant. This is further undermined by the overall weak institutional environment. The reliability of corporate information is limited, statutory auditors are not independent and courts are inexperienced in corporate cases.

In Russia requesting an internal audit of the company's financial documentation is regarded the most effective action. The procedure is clear and the time usually limited to five months, although it is easy for the defendant to delay the proceedings. In addition, enforcement can be problematic due to several deficiencies in the Russian court system.

In Armenia, similarly to Poland, minority shareholders holding at least 10 per cent of the shares have, by virtue of law, the right to nominate a representative to the supervisory board.[18] As in Russia, requesting an internal audit is considered the most effective action among those available. However, reliability of auditing in Armenia might be an issue as the limited presence of international auditing firms in the country suggests.

- a liability suit against the company holding the majority stake (and/or its subsidiary on the other side of the transaction and/or its directors) on behalf of the company
- a direct liability suit against the company holding the majority stake (and/or its subsidiary on the other side of the transaction and/or its directors) for damages incurred by the minority shareholder
- an action against the counterpart to the transaction to obtain the disgorgement of the profits made out of the transaction.

The questionnaire also asked whether enforcement mechanisms other than civil courts were available (for example, criminal prosecution, national or international arbitration, action before the securities regulator and the stock exchange). Once again practitioners were free to supplement this choice with additional remedies.



Once an abusive related-party transaction has been detected, the legal framework must offer effective mechanisms for minority shareholders to obtain redress.

In Georgia asking the court to appoint an independent auditor and/or calling a general shareholders' meeting to question the company's management are judged to be the best mechanisms to obtain disclosure. Nonetheless, such procedures are quite complex and might be very difficult to enforce.

In the Kyrgyz Republic several courses of action are available to minority shareholders but the procedures are likely to last more than one year. Furthermore, given the weak institutional environment, the outcome of any action is unpredictable. Company books are considered unreliable and may therefore be useless even if disclosure is obtained.

Redress mechanisms

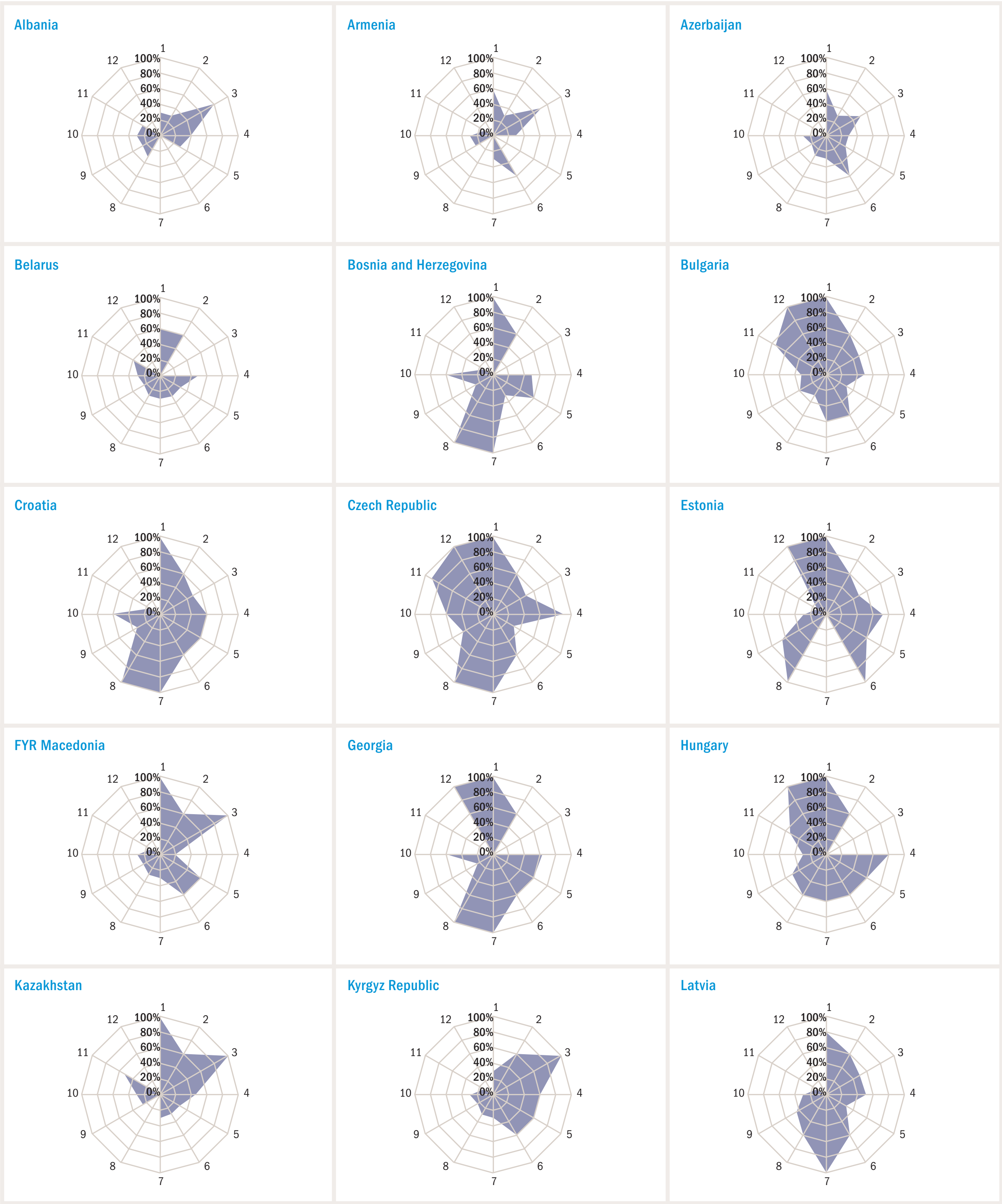
Once an abusive related-party transaction has been detected, the legal framework must offer effective mechanisms to obtain redress. Local practitioners were asked to indicate what legal remedies were available to the minority shareholder in the case study scenario. A choice of possible remedies was listed in the questionnaire, including:

- a challenge to the validity of the transaction, that is to say rescission
- a liability suit against the company's directors on behalf of the company (a derivative suit)
- a direct liability suit against the company's directors for damages incurred by the minority shareholder

For each of the remedies the usual questions on availability, speed, simplicity and enforceability were posed. Respondents were also asked to assess the costs of the legal remedy they deemed to be most effective. More specific questions were also included with regard to civil and criminal actions.

In general, it can be observed that in all transition countries except Bosnia and Herzegovina, Bulgaria [19] and Estonia, minority shareholders have several options for legal action. Unsurprisingly, however, the effectiveness greatly varies from action to action and from country to country. In many instances minority shareholders can face endless delays and enforcement difficulties.

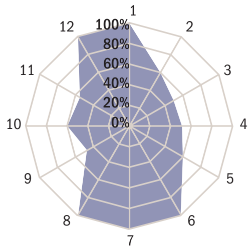
Chart 2 Institutional environment affecting corporate governance in transition countries



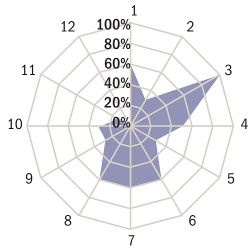
Notes: Institutional environment refers to the capacity of a country's legal framework to effectively implement and enforce corporate governance legislation. Statutory background relates to whether a comprehensive, clear and well structured definition of related-party, self-interested, self-dealing or conflict of interest is provided by the country.
In particular, whether this definition covers transactions in which the director or the dominant shareholder has an indirect interest (for example, the party to the transaction is a dominant shareholder's subsidiary). Institutional integrity refers to the level of corruption within a transition country, as determined by Transparency International's Corruption Perception Index 2005. This index is measured on a scale from 1 to 10, with 1 being the most and 10 the least corrupt environment. The extremity of each axis on the graph represents an ideal score: the fuller the 'web', the better the institutional environment. Data was collected for 26 of the EBRD's countries of operations and Mongolia.

Source: EBRD Legal Indicator Survey 2005.

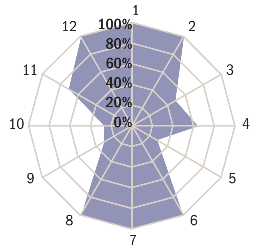
Lithuania



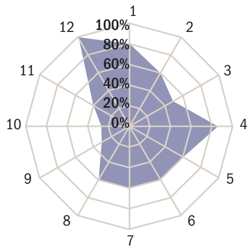
Moldova



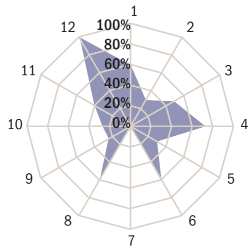
Poland



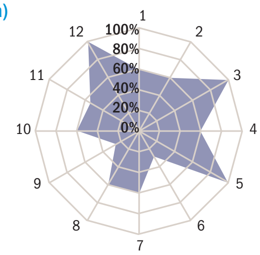
Romania



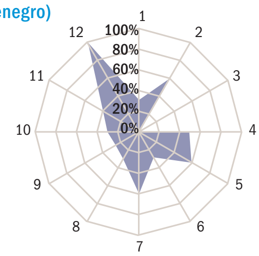
Russia



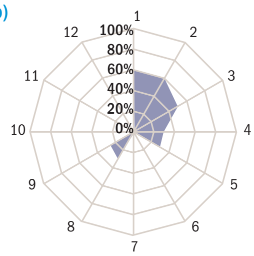
Serbia and Montenegro (Serbia)



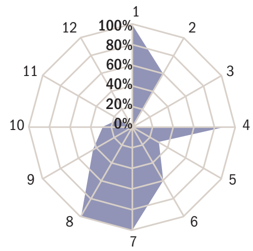
Serbia and Montenegro (Montenegro)



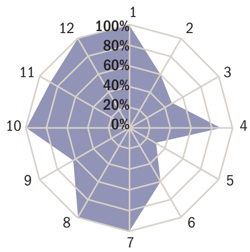
Serbia and Montenegro (Kosovo)



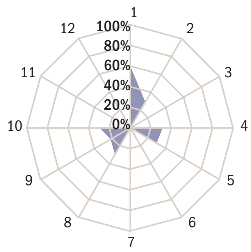
Slovak Republic



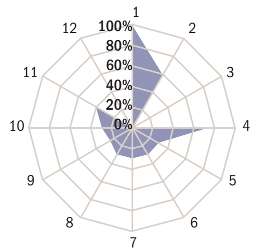
Slovenia



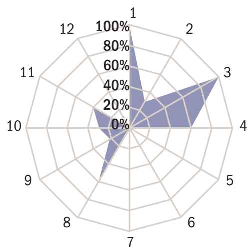
Tajikistan



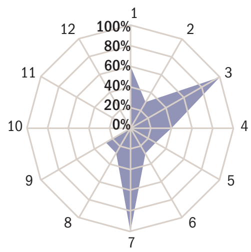
Ukraine



Uzbekistan

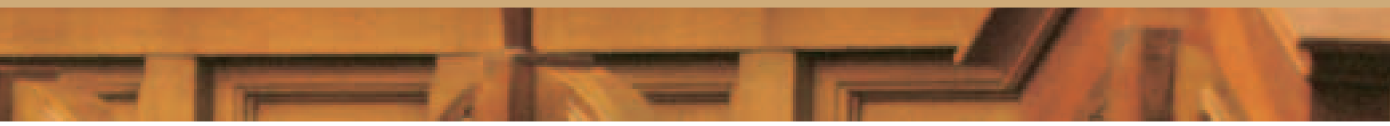


Mongolia



1 Reliability of company's books
2 Independence of statutory auditors
3 Statutory background
4 Competence and experience of courts
5 Competence and experience of prosecutor
6 Competence and experience of market regulator
7 Impartiality of market regulator
8 Impartiality of courts
9 Institutional integrity
10 Possibility for defendant to delay proceedings
11 Availability of precedents
12 Use of precedents by lawyers

In most transition countries, minority shareholders have several options for legal action. Unsurprisingly, however, the effectiveness of these options vary greatly from action to action and from country to country. In many instances, minority shareholders can face endless delays and enforcement difficulties.



Central Europe and the Baltic states

Among CEB countries, the Czech Republic and Slovenia appear to have the most effective mechanisms for redress while the framework is somewhat weaker in Hungary, Latvia and Poland. The estimated time needed to obtain an executable judgement varies across the region from about one year in Estonia to two or more years in the Czech Republic, Hungary and Poland. Local practitioners reported that redress procedures can be particularly awkward in Hungary and Poland, but are generally straightforward in the Czech Republic and Slovenia. Enforcement can be problematic in Hungary, yet is considered simple in Slovenia.

Survey results for Slovenia confirm that the corporate governance framework is as effective for redress as for disclosure. The Czech Republic similarly has a sound institutional environment with effective enforcement and clear procedures. The only relative weakness in both countries is the time needed for concluding an action (often exceeding two years).

In general, the situation in Estonia concerning redress is better than for disclosure. Only the direct liability action against the company's management is available, but it is considered reasonably effective. The proceedings are not particularly complex and the burden of proof required to a minority shareholder not particularly heavy. However, as evidenced before, obtaining disclosure in Estonia might be a problem.

South-eastern Europe

Romania and Serbia have the most effective legislations in the SEE region regarding redress. Major weaknesses are evident in Bosnia and Herzegovina and Kosovo. The average time needed to obtain an executable judgement is likely to vary from 18 months in Romania to more than five years in Serbia and Kosovo.

Challenging the validity of a related-party transaction is the only legal remedy available in Bosnia and Herzegovina and its effectiveness is limited. Courts have a backlog of cases and, despite strict time limits set by law, the complex legal proceedings can drag on for several years. Legal effectiveness is further undermined by a weak institutional environment.

In Bulgaria procedures are not particularly smooth and this can lead to enforcement difficulties. The time required to reach an executable judgement can be up to two years and the defendant can easily delay the process further.

In Romania and Serbia and Montenegro minority shareholders can choose between several different procedures which are generally deemed to be clear and enforcement does not appear to be an issue. However, while in Montenegro the time needed to conclude proceedings is generally limited to three years, courts in Serbia are not bound by any mandatory deadlines and the procedures can last up to 10 years.

Commonwealth of Independent States

As with disclosure, the legal framework for redress is deficient in all CIS countries. Enforceability is a problem across the region, and procedures are deemed particularly complex in Ukraine. Also, the institutional environment has significant flaws in all countries. The time needed to obtain an executable judgement is generally short, but in many instances it is reported easy for the defendant to delay the proceedings.

In Azerbaijan the available mechanisms are considered relatively effective although the procedure can be complex.[20] Enforceability is usually not a substantial problem, and the time needed to conclude the action is limited to 18 months. The major obstacles can be the ease by which the defendant can delay the proceedings and courts' bias in favour of powerful defendants.

In Russia challenging the validity of the transaction is reported to be the most effective action, but enforcement of court decisions can be problematic.

Armenia, Belarus and Tajikistan appear to have the least effective legislation, the lowest degree of judicial competence and perform badly in terms of enforcement of court decisions.

Other enforcement mechanisms

The effectiveness of corporate governance mechanisms depends not only on courts but also on other public and private enforcement institutions.[21] Private enforcement institutions include arbitration courts and stock exchanges. In addition, pressure exerted on insiders' behaviour by the media,[22] shareholders' associations or embassies may also have a positive effect when either listed companies or foreign investors are involved.

Arbitration

As an alternative to actions before the court, local practitioners were asked to assess the availability and effectiveness of national and international arbitration procedures, according to the same variables considered above. In order to assess the availability of arbitration, respondents were asked whether a provision in the company's charter would suffice to start arbitration proceedings or whether instead an agreement among the disputing parties would be necessary.

In CEB, arbitration for this type of situation is generally available in all countries, but some limitations apply. In Estonia and Lithuania a specific agreement must be concluded with the other party before starting the procedure, thereby limiting the effectiveness of this possibility.[23] In Hungary proceedings are complex and enforceability may be difficult. In Poland the enforceability of the award is generally simple and straightforward, but the procedure may take up to three years.

With respect to SEE, the survey revealed an uneven situation throughout the region. Practitioners in Bulgaria revealed the exclusive competence of courts on the issues described in the case studies. Meanwhile in Bosnia and Herzegovina the law on civil procedure allows for the formation of "ad hoc arbitration" which is not deemed applicable to the scenario under analysis. In Albania arbitration is considered a valid alternative to the weak judicial environment. Contrastingly, in Kosovo arbitration is felt generally ineffective since general enforcement mechanisms are limited and their effectiveness highly unreliable.

Finally, arbitration for this type of dispute in the CIS is not an effective option. In Tajikistan, although arbitration is in theory available, its lack of enforceability renders the option unrealistic. In Uzbekistan the courts settle all disputes between national entities. International arbitration is available in case one party is foreign and a specific agreement between the parties is concluded. In Moldova and Russia arbitration for this type of situation is considered relatively effective, although proceedings can be quite complex and the enforceability of the award can be problematic.

Action before the stock exchange[24]

The survey found that, for a minority shareholder in a listed company, an action before a stock exchange to obtain enforcement of the relevant provisions in the listing rules is available in seven countries.[25] Local consultants reported the action to be quite effective in Romania and Slovenia. In FYR Macedonia, Kazakhstan and Russia it can also lead to positive results, while substantial doubts have been raised about its effectiveness in Latvia. Procedures are considered complex especially in Kazakhstan and Russia and particularly long in FYR Macedonia and Russia.

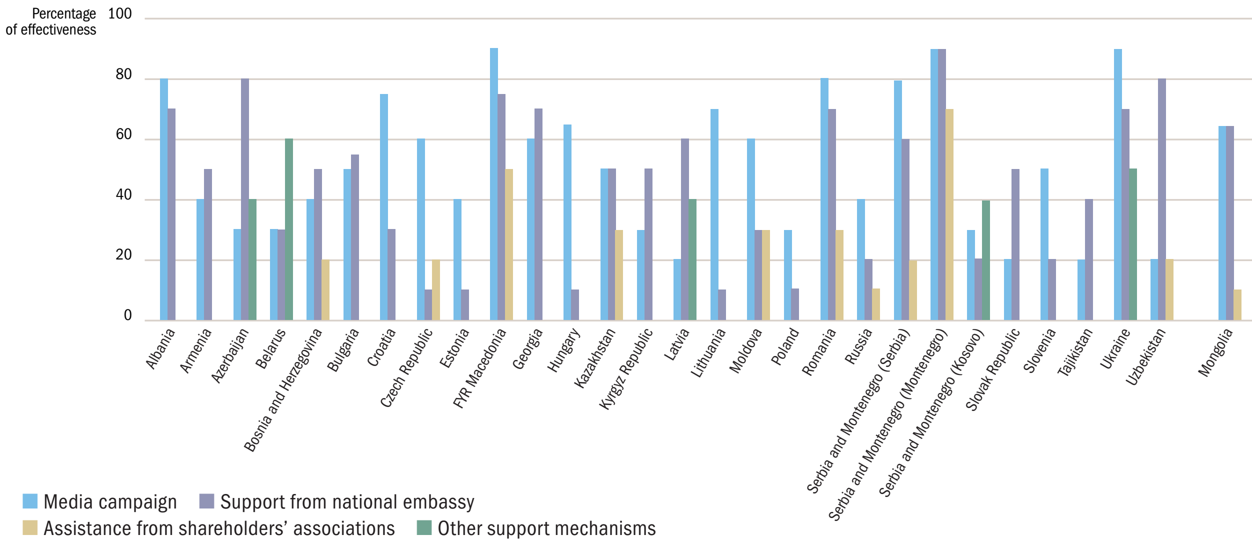
Action before the market regulator

All countries in the EBRD region have a securities market regulator. However, an action before the regulator to obtain administrative sanction or some other enforcement action against the company's directors or dominant shareholders is feasible in only 12 countries.[26]

In Armenia, Georgia, Hungary and Uzbekistan the action is considered quite ineffective, while in Bulgaria, Lithuania, Romania and Slovenia it can produce a positive outcome. Enforceability of the market regulator's decision is relatively smooth in Georgia, Hungary, the Kyrgyz Republic, Lithuania and Mongolia, while difficult in Russia and Kazakhstan. The length of the procedure is an issue especially in Armenia, Georgia, the Kyrgyz

The effectiveness of corporate governance mechanisms depends not only on the civil courts, but also on other enforcement institutions, such as arbitration courts and stock exchanges.

Chart 3 Effectiveness of mechanisms supporting corporate governance legal actions



Note: Scores range from 0 to 100%, with 100% indicating the most effective support mechanism.

Source: EBRD Legal Indicator Survey 2005.

Republic, Lithuania, Moldova, Mongolia and Uzbekistan, yet it can be particularly fast in Hungary and Slovenia. The procedure is held to be smooth in Bulgaria, Lithuania, Moldova, Romania and Slovenia and complex in Armenia, Georgia, Hungary, Russia and Uzbekistan.

The market regulator is deemed to be highly competent and experienced especially in Estonia, Lithuania and Poland.

Support for action

The survey also asked whether the plaintiff should consider other support mechanisms for their actions. In several countries a media campaign was considered to be a good support for the action, with particularly high ratings in Albania, FYR Macedonia, Montenegro, Romania, Serbia and Ukraine. Requesting support from the national embassy – bearing in mind that the minority shareholder in the case studies was a foreign investor – was instead considered helpful especially in Azerbaijan, FYR Macedonia, Montenegro and Uzbekistan.

Only in FYR Macedonia, Montenegro and Romania (for listed companies only) was support from a shareholders' association judged to be helpful (see Chart 3).

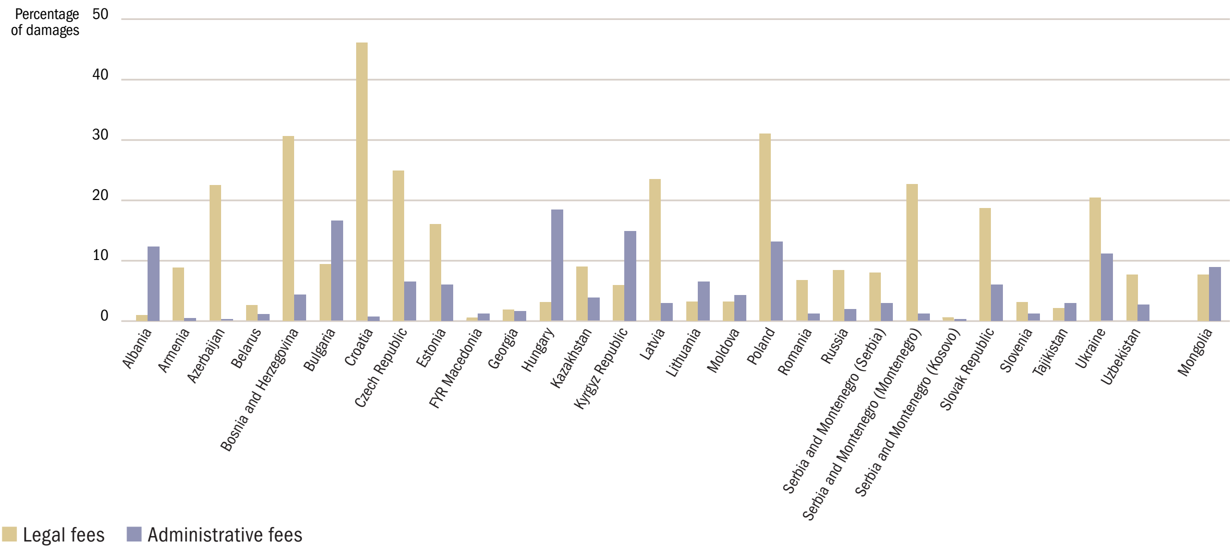
How much does it cost to obtain redress?

Practitioners were asked to assess the expected costs of the legal action they deemed most effective in obtaining redress. A few questions were also designed to learn about the rules on attorney's fees in shareholder suits. Especially in publicly listed companies, the prospect of having to pay lawyer's fees as well as the winning defendant's fees provides a great disincentive to shareholder suits.

Ideally, countries should allow for "no win – no fee" agreements, as seen in the US and Japan. Under this agreement, a shareholder bringing a *bona fide* suit should not have to pay their lawyers' fees (contingency fees) or the defendants' fees if they lose the case. This principle ensures that minority shareholders bringing an action against insiders' wrongdoing will not have to compensate the defendant should their case be unsuccessful. However, as most countries in the survey do not have this rule, minority shareholders rarely challenge insiders' behaviour in court. As a result, laws protecting minority shareholders are under-enforced and less effective.

Estimating legal costs is a difficult exercise as it depends on a number of circumstances, several of which are unpredictable. Bearing this in mind, the survey evidenced that in CEB legal costs were estimated to be less than 5 per cent of the damage suffered by the plaintiff in Hungary, Lithuania and Slovenia while at the other extreme, more than 20 per cent in Croatia, the Czech Republic, Latvia and Poland. In SEE legal costs were estimated in a range of less than 2 per cent in Albania and FYR Macedonia to more than 20 per cent in Bosnia and Herzegovina and Montenegro. In the CIS the costs were put at less than 3 per cent in Belarus, Georgia and Tajikistan and at more than 20 per cent in Azerbaijan and Ukraine.[27]

Chart 4 Costs associated with legal actions taken by minority shareholders



Note: Estimated costs are shown as a percentage of the damages suffered by the plaintiff in the case study scenarios.

Source: EBRD Legal Indicator Survey 2005.

Apart from lawyers' fees, administrative fees and costs should also be considered as they have to be advanced by the plaintiff when filing the suit. The survey discovered that administrative fees are particularly high in Albania, Bulgaria, Hungary, the Kyrgyz Republic and Poland.

According to the survey, in six of the CEB countries (Croatia, Estonia, Latvia, Lithuania, the Slovak Republic and Slovenia), three countries in SEE (Albania, Bosnia and Herzegovina and FYR Macedonia) and nine countries in the CIS (Azerbaijan, Armenia, Georgia, Kazakhstan, the Kyrgyz Republic, Russia, Tajikistan, Ukraine and Uzbekistan) it would be possible to conclude an agreement between the law firm and the plaintiff so that the latter would not have to pay the law firm if the action was rejected.

In all CEB and SEE countries and in six CIS countries (Azerbaijan, Kazakhstan, the Kyrgyz Republic, Moldova, Tajikistan and Ukraine), the plaintiffs must pay the defendants' fees if they lose the case. Likewise, the defendants must pay the plaintiffs' fees if they lose the case. In two of the CEB countries (Hungary and the Slovak Republic), three countries in SEE (Bosnia and Herzegovina, Romania and Serbia and Montenegro – Serbia and Kosovo only) and in Belarus in the CIS, lawyers are not allowed to agree with the client a share in the damages awarded.

Finally, class actions are available in Latvia, Lithuania, the Slovak Republic and Slovenia in CEB, Romania in SEE, and Georgia, the Kyrgyz Republic and Russia in the CIS.[28]

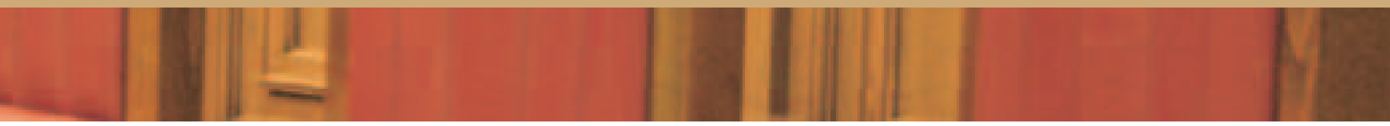
Conclusion

The 2005 Legal Indicator Survey confirms that related-party transactions remain an issue for concern in all transition countries. The degree to which minority shareholders can obtain effective disclosure or redress is limited, and well below what could be expected when looking at the laws.

Disclosure and redress are inextricably linked. This is because an action for redress can only be initiated when evidence is secured. The assessment reveals that requesting a general shareholders' meeting is the most common action provided by law to minority shareholders, but it is unlikely to produce any disclosure when the company is controlled by a powerful

The prospect of a minority shareholder having to pay their lawyer's fees, as well as the defendant's legal fees should their action be rejected, provides a great disincentive for shareholders trying to obtain redress.

Even excellent laws can suffer from poor implementation. This undermines the usefulness of legal provisions and diminishes the confidence of foreign investors in the legal system as a whole. Most transition countries need to upgrade their commercial laws to standards that are generally acceptable on an international level.



shareholder. In cases of obvious misconduct, criminal proceedings are available by law in all countries in the region, but the vast majority of contributing practitioners expressed serious doubts as to the experience and competence of prosecutors in corporate cases.

Three main conclusions can be drawn. First, countries that have developed a solid institutional environment can generally offer an effective legal framework. Nevertheless, as demonstrated by the issue of disclosure in Estonia, this alone is not enough to give minority shareholders adequate protection against abusive behaviour by controlling shareholders. The sound environment needs to be coupled with a corporate governance framework in line with international standards and with an effective civil procedural framework.

Second, consistent with previous studies on shareholder and creditor rights in transition countries, the survey shows that new EU member states and candidate countries,[29] while displaying a better institutional environment, do not systematically outperform other transition countries with regard to the effectiveness of disclosure or redress mechanisms.

Finally, even excellent laws can suffer from poor implementation. This undermines the usefulness of legal provisions and diminishes the confidence of foreign investors in the legal system as a whole – in particular, in its ability to uphold contractual rights. Most transition countries need to upgrade their commercial laws to standards that are generally acceptable at an international level. Even more importantly, they must make those laws fully effective, particularly through strengthening their court systems, tackling corruption and adopting appropriate measures to strengthen the rule of law.

Notes

[1] The assessment was financed by the government of the United Kingdom. The assessment refers to legislation in place on 30 September 2003. The results are available at: www.ebrd.com/country/sector/law/corpgov/assess.

[2] The initiative was funded by the Italian government. See: www.ebrd.com/country/sector/law/corpgov.

[3] See S Djankov, R La Porta, F Lopez-de-Silanes and A Shleifer (2005), *The Law and Economics of Self-Dealing*, p. 36 (emphasis in the original), available at: http//post.economics.harvard.edu/faculty/shleifer/papers/. The Djankov *et al.* paper similarly devises a case study involving a self-dealing transaction and uses responses from practitioners in a number of jurisdictions to analyse the treatment of self-dealing transactions across the globe.

[4] The EBRD has 27 countries of operations, geographically divided into three regions: central Europe and the Baltic states (CEB): Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia; south-eastern Europe (SEE): Albania, Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Romania, Serbia and Montenegro; Commonwealth of Independent States (CIS): Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. For the LIS, data on Turkmenistan were not available. Results for Serbia and Montenegro are represented separately (Serbia, Montenegro and Kosovo) for illustrative purposes only. Mongolia, which is not yet an EBRD country of operations, was also surveyed.

[5] The results of previous Legal Indicator Surveys are available on the EBRD web site. The LIS on insolvency is available at: www.ebrd.com/country/sector/law/insolve/insolass/lis/index and the LIS on enforcement of charges is available at: www.ebrd.com/country/sector/law/st/facts/ecs.

[6] The following law firms, among others, contributed to and supported the 2005 LIS: Studio Legale Tonucci (Albania and Romania); Chadbourne & Parke LLP (Azerbaijan, Belarus, Kazakhstan, Kyrgyz Republic, Russia, Ukraine, Uzbekistan); Advokat (Bosnia and Herzegovina); Spasov and Bratonov Lawyers' Partnership (Bulgaria); Wolf Theiss (Croatia and Serbia, Montenegro and Kosovo); Linklaters (Czech Republic, Poland and Slovak Republic); Luiga, Mugu & Borenius (Estonia); Mgaloblishvili, Kipiani, Dzidziguri (MKD) Law Firm (Georgia); Ormai es Tarsai CMS Cameron McKenna (Hungary); Sorainen Law Offices (Latvia); Lideika, Petrauskas, Valiunas & Partners (Lithuania); Law Office Polenak (FYR Macedonia); Turcan & Turcan (Moldova); Colja, Rojs & partnerji (Slovenia); Akhmedov, Aziziv & Abdulhamidov Attorneys (Tajikistan); Lynch & Mahoney law offices (Mongolia).

[7] For those countries where there is no active stock exchange, Alfa Ltd was imagined as a large open-type company with numerous minority shareholders.

[8] The questionnaires were sent out in early June 2005. Answers were received in June-July 2005. Before treating the data, a number of additional questions and requests for clarifications were sent to the respondents.

[9] The presence of the "big four" auditing firms is a proxy for the quality of the audit profession in the country. The importance of well-trained accountants for corporate governance is discussed in OECD (2004), "Corporate governance in Eurasia: a comparative overview", available at: www.oecd.org/dataoecd/18/63/33970662.pdf.B S Black (2001), "The legal and institutional preconditions for strong securities markets", *UCLA Law Review* 781, Vol. 48, pp. 781-855, includes "[a] sophisticated accounting profession with the skill and experience to catch at least some instances of false or misleading disclosure" among the "core institutions that control information asymmetry" and hence among the preconditions for strong securities markets.

[10] See: ww1.transparency.org/cpi/2005/cpi2005.sources.en.html.

[11] In some instances questionnaires were answered by just one practitioner within a leading law firm. In other instances, the questionnaire was addressed by a team of practitioners.

[12] See OECD Principles of Corporate Governance, Principles II and V.

[13] See, for example, Djankov *et al.*, supra note 3.

[14] In case the request is refused, the shareholding required to petition the court for the appointment of an independent auditor is 25 per cent.

[15] In contrast to the unlisted company case study, the listed company scenario allows minority shareholders to request an independent audit or request the court to appoint one.

[16] According to UNMIK Regulation 24/1999 on the law applicable in Kosovo (as amended on 27 October 2000 by Regulation 2000/59), the applicable law is composed by "the regulations promulgated by the Special Representative of the Secretary-General (...) and the law in force in Kosovo on 22 March 1989. In case of a conflict, the regulations shall take precedence. If a court (...) determines that a (...) situation is not covered by the [above mentioned] laws but is covered by another law in force in Kosovo after 22 March 1989 which is not discriminatory (...) the court as an exception, shall apply that law."

[17] UNMIK Regulation 2001/6 on business organisations; Regulation 2001/30 on the establishment of the Kosovo board on standards for financial reporting and regime for financial reporting of business organisations; Administrative Direction 2002/22 implementing UNMIK regulation 2001/6 on business organisations.

[18] See D Karapetyan (2002), "Shareholder rights: theory and practice in Armenia", OECD, available at: www.oecd.org/dataoecd/41/42/2096900.pdf.

[19] In Bulgaria actions available to minority shareholders in the unlisted company scenario are limited to the derivative suit.

[20] Two actions are available in Azerbaijan: challenging the validity of the transaction and a direct liability suit against the company's management.

[21] See E Berglöf and S Claessens (2004), "Enforcement and Corporate Governance", World Bank Policy Research Working Paper No. 3409, http://ssrn.com/abstract=625286, 20.

[22] Id.

[23] A specific provision in the company's charter was not considered enough.

[24] In the EBRD countries of operations, the stock exchange is reported to be inactive in Albania, Armenia, Kosovo and Tajikistan. In Belarus there is a functioning stock exchange but it is generally limited to hard currency transactions and government papers, while there are only a few joint-stock companies listed.

[25] The action is available in FYR Macedonia, Kazakhstan, Latvia, Lithuania, Romania, Russia and Slovenia.

[26] The action is available in Armenia, Bulgaria, Georgia, Hungary, Kazakhstan, the Kyrgyz Republic, Latvia, Lithuania, Moldova, Romania, Russia, Sloveniaand Uzbekistan.

[27] The estimate has been calculated taking into consideration the likely legal fees stated by law firms compared with the average damage suffered by the minority shareholders in the two case studies.

[28] Defined broadly as a lawsuit brought by one or more plaintiffs on behalf of a large group of others who have an identical claim (for example, an action filed by one shareholder on behalf of other shareholders).

[29] See, for example, K Pistor (2004), "Patterns of legal change: shareholder and creditor rights in transition economies," *European Business Organization Law Review*, Vol. 1, No. 1, pp. 59-110, available at: ssrn.com/abstract=214654.

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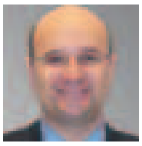
Corporate governance in EBRD banking operations



Norbert Seiler
Deputy General Counsel, EBRD

Through its investments, the EBRD seeks to improve corporate governance. This article highlights initiatives undertaken by the Bank to facilitate transition and to strengthen governance in the companies in which it invests.

A significant proportion of the EBRD's activities in central Europe and central Asia over the past 15 years has been in equity investments. The Bank has acquired significant equity stakes in many state-owned enterprises, supporting preparations for their privatisation. The Bank has also invested in the equity of many private sector enterprises, across a wide range of industries, to assist them in their future development and growth.

The Bank's presence among the shareholders of a company provides comfort to other investors. It signals that the company has passed the Bank's rigorous due diligence procedures. The Bank's presence is also perceived as a measure of protection against political risk in the sometimes challenging investment climate of the transition countries. In addition, the Bank's participation in many private equity funds active in the region has facilitated the supply of equity capital to small and medium-sized enterprises.

At the end of 2005 the Bank's equity portfolio consisted of equity investments in more than 400 companies totalling over €2,200 million. Cumulatively, since its inception in 1991, the Bank has held equity stakes in close to 700 companies worth €5,400 million (see Chart 1).

The EBRD's primary purpose is to assist the countries of central eastern Europe and the Commonwealth of Independent States in their transition from centrally planned to market economies. Therefore, EBRD transactions are not merely expected to generate adequate financial returns. The Bank's investments should also make a positive contribution to the transition process.

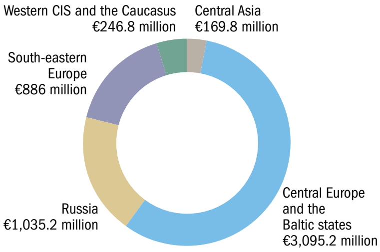
In the context of its equity investments, the Bank's main impact on transition comes from a variety of measures used to address shortcomings in governance and business practices. For a large part of the last century, enterprises in the region were not exposed to market pressures and instead responded primarily to the demands of planning agencies. These previously state-owned enterprises have only recently had to take into account the legitimate interests and demands of private shareholders and other stakeholders.

In many cases, state assets have been transferred to newly formed enterprises that are managed in the interest of a single shareholder or a small group of dominant shareholders. In these enterprises, little regard is paid to the legitimate interests of minority shareholders and other stakeholders.

Many of these companies exhibit opaque ownership and control structures allowing one or more individuals to exert influence over the affairs of the enterprise. As a result, other shareholders are left in the dark about the enterprise's strategic orientation.

The Bank is encouraging all its investee companies to adhere to best international standards of corporate governance. Good corporate governance arrangements have many benefits. They seek to ensure that the individuals directing the affairs of a company act in the best interests of all shareholders. They also prevent individuals from exploiting conflicts of interest and reduce the incidence of corruption. On a broader level, good corporate governance can attract new investors and keep existing ones, ultimately enhancing a company's value.

Chart 1 EBRD equity portfolio, by region



Source: EBRD 2005.

The EBRD's guiding principles for corporate governance and good business practices are summarised in the publication *Sound business standards and corporate practices – A set of guidelines*.[1] The guidelines point out that the success of any enterprise is based on sound relations with its shareholders, customers, employees, suppliers, the government and local authorities, and the community at large. It also sets out the measures to be taken towards these objectives.

The Bank has also participated in the preparation of the OECD Principles of Corporate Governance, which were first published in 1999 and updated in 2004. The OECD Principles describe corporate governance as follows:

> *"Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring."*

The corporate governance arrangements at any enterprise are rooted in a variety of sources. Company law and other statutory instruments, such as securities laws and regulations, provide the broad legislative framework. Many aspects of corporate governance are also implemented in the charters, by-laws and similar instruments adopted by individual companies. Ultimately, corporate governance depends on the attitude and quality of the individuals charged with the management and control of a company.

The EBRD seeks to address all these different dimensions of corporate governance. Through its Legal Transition Programme the Bank monitors and assesses the legislative framework for corporate governance, while providing expert advice to governments and their agencies to support reform efforts in this area. The Bank's work on these broader, systemic conditions for good corporate governance is discussed elsewhere in this edition of *Law in transition*. This article focuses instead on the EBRD's approach towards improving the corporate governance arrangements of its investee companies in the context of its equity investments.

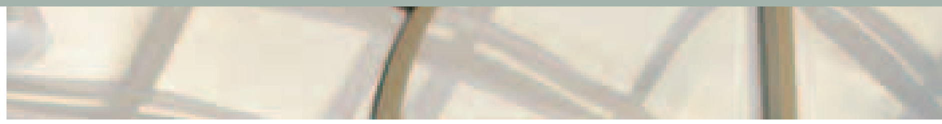
Nomination of board members

In many of its equity investments the Bank secures the contractual right to nominate one or more members to the governing body (board of directors, supervisory board) of the investee company. The paramount task of these nominees, who may be either experienced EBRD employees or suitable consultants, is to exercise their board duties with a view to improving the corporate governance arrangements of the company. At present, the Bank has nominated approximately 300 individuals to serve on the governing bodies of some 250 portfolio companies.

In connection with their appointment, all EBRD nominees receive a set of guidelines setting out their main duties. The EBRD expects its nominees to:

- act in the best interest of the company; they are accountable to the company as a whole and all its shareholders, not to the EBRD or any other particular shareholder
- familiarise themselves with the charter of the company as well as applicable laws and regulations, and monitor closely the company's compliance with all laws, regulations and internal rules
- participate actively in all affairs of the company body to which they are appointed, clearly express their views, and see that these views are accurately reflected in the minutes
- insist on receiving clear, accurate and meaningful financial information from the management of the company, and where necessary propose the establishment of reliable management information systems
- where appropriate, request audited financial statements and management reports, as well as auditors' reports and management letters
- scrutinise the financial information supplied to them for any undisclosed items which could conceal money laundering, fraudulent transactions or illicit payments to government officials and business associates
- propose procedures for uncovering, investigating and reporting suspicious transactions, if internal control mechanisms are weak
- require strict compliance with all environmental laws and regulations, as well as those relating to health and safety in the workplace

As defined by the OECD, corporate governance involves the set of relationships between a company's management, its board, its shareholders and other stakeholders.



- demand that the board receives regular information about the implementation of any environmental covenants or action plans which may have been adopted in connection with the EBRD's investment
- ensure that they avoid conflicts of interest in the course of their duties, and do not participate in the deliberations and decision of any matter in which they have a conflicting interest.

Specific corporate governance enhancement measures

The Bank's concern for good corporate governance arrangements permeates all aspects of its approach to its transactions. Whenever preliminary investigations into a potential investment indicates corporate governance deficiencies, the Bank reviews the current arrangements by performing a "corporate check". Such a check is often carried out with the assistance of outside counsel and other external professional advisers. This analysis enables the Bank to alert its client of concerns and to develop a remedial action plan addressing the corporate governance flaws identified. In anticipation of the EBRD's investment, the company may correct some defects through charter amendments.

Other aspects may require sustained efforts over a period of time after the Bank has become a shareholder of the company. The various investment conditions and implementation guidelines are set out in the legal documentation governing the Bank's equity investment (subscription agreements, share purchase agreements and shareholders agreements).

Analysing a company's corporate governance

The Bank's analysis of an investee company's corporate governance arrangements involves the thorough review of its charter, minutes of the meetings of shareholders and directors, and all other company documents. The following issues are of particular importance:

Share register

It is the EBRD's preference that company shares are registered with an independent registry. Where the company itself maintains the share register, the Bank must be satisfied that the registration arrangements are adequately reliable. A reliable share register is crucial to the Bank's assessment of whether ownership and control over the company (often a key factor in the Bank's investment decision) is properly disclosed and recorded. Any mismatch would require further analysis.

Voting rights

Shares of the same class should confer the same voting rights. Special voting and any other rights attached to any class should be fully disclosed to all shareholders.

Transferability of shares

As a general principle, shareholders should be entitled to dispose freely of their shares.

Annual general meeting

The company should hold annual shareholders' meetings within a specified time frame (for example, six months) following the end of the company's fiscal year.

Shareholders' meetings

The Bank generally procures that its shareholding be allowed to request an extraordinary shareholders' meeting. All shareholders should be notified in advance of the agenda of any shareholders' meeting. They should be able to participate in such meetings through proxies or substitutes on the basis of a power of attorney.

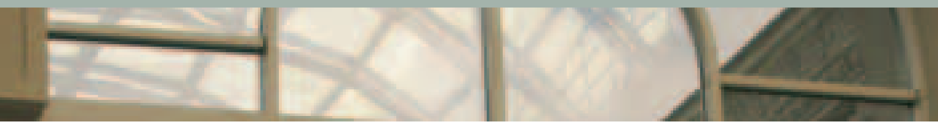
Disclosure of conflicts of interest

Arrangements should be in place to ensure that a shareholder, director, officer or employee of a company, who has material interests in a proposed transaction with the company, discloses these interests and is restricted from participating or voting in the meeting where the matter is to be discussed.

Related-party transactions

Similarly, all transactions made by the company with related parties (such as parent companies, subsidiaries, directors, employees or their spouses, children or relatives of the company or related companies) should be specifically disclosed and approved by the relevant governing body of the company.

When analysing a company's corporate governance, the EBRD is particularly interested in the share register, voting rights, transferability of shares, timing of annual general meetings, ability of shareholders to call extraordinary meetings, disclosure of conflicts of interest and the company's decision-making processes.



Decision making

At a minimum, shareholders, via shareholders' meetings, should have the right to take all of the following decisions:

- elect or dismiss the board of directors
- appoint the company's external auditors and approve its annual audited financial reports
- authorise dividend proposals and approve the issuance of additional shares
- amend charter, articles of association, by-laws or other fundamental corporate documents
- authorise the sale of a substantial portion of corporate assets, and approve the merger, re-organisation, winding up or voluntary liquidation of the company
- approve stock option plans and similar incentive schemes for the company's directors, officers and employees.

The Bank also requires the adequate allocation of responsibilities among the company's management and its board of directors for the following:

- reviewing annual budgets and business plans
- establishing performance objectives
- monitoring implementation and corporate performance
- overseeing major capital expenditures, acquisitions and divestitures
- selecting, compensating, monitoring and replacing key executives and overseeing succession planning
- reviewing the company's remuneration policies for its board, key executives and other employees
- monitoring and managing potential conflicts of interest of management, board members and shareholders
- ensuring the adequacy and integrity of the company's accounting and financial reporting systems
- overseeing the process of disclosure and communications to the local authorities and the general public.

Implementing institution-building plans

Usually the Bank insists that any amendments to the investee company's charter – which may be required to address fundamental corporate governance shortcomings – are effected prior to the Bank's investment. Other areas of improvement in the company's governance arrangements, which may have been identified during the EBRD's investigations, are captured in institution-building plans. These are formally endorsed by the company and its main shareholders and become part of the legal documentation for the Bank's investment transaction.

Through these institution-building plans, the EBRD identifies development objectives for the governance arrangements at its investee companies. The plans also assist in ascertaining the company's organisation and internal procedures, as well as their risk management and control functions. Any such plan sets milestone dates by which various identified remedial steps are to be implemented. Responsibility for implementing these steps is assigned to a task force chaired by a suitable individual (such as a senior executive or member of the board of directors) who is encouraged to draw on the assistance of external advisers where necessary.

This person is to develop detailed implementation arrangements for the consideration and approval of the company's board of directors.

While all institution-building plans are designed to fit the particular needs of the investee company, most:

- provide for measures to increase the effectiveness of the board of directors. This done, for example, by stipulating a reduction in the number of members, or the replacement of less qualified members with more suitable individuals.
- regularly call on the board of directors to establish from among its members an audit committee and a compensation committee. Draft terms of reference are usually provided for both committees. The audit committee should oversee the audit and compliance functions of the company, while the compensation committee focuses on the company's overall compensation structure and executive incentive compensation schemes.
- itemise steps to be taken to enhance the effectiveness of the management board. The plans call for a comprehensive review of the line management responsibilities of members of the management board. It also demands the improvement of the existing management reporting system or the development of new management reports. Other objectives may be the decentralisation of the decision-making authority of non-essential business functions, from top management to other executives, and the adoption of "business performance contracts" for senior executives whereby their compensation levels are tied to the performance of the company.

Institution-building plans commit the company to perform a thorough review of its organisational structure with a view to achieving a clear delineation of responsibilities between various functional lines avoiding inefficiencies, overlaps in responsibilities and internal competition.

Plans also include the implementation of procedures calling for the preparation of clear, transparent business plans and the enhancement of the company's internal audit and compliance functions.

Conclusion

The various initiatives to enhance corporate governance in the EBRD's investee companies constitute an important element of the Bank's transition impact. In advanced jurisdictions, adequate corporate governance structures are usually stipulated in the applicable laws and regulations.

The legal assessment work undertaken by the Bank demonstrates that the legal and regulatory environment of many transition countries lags behind best international practice. For this reason, the Bank has adopted alternative means to improve corporate governance within its investee companies. The appointment of skilled, dedicated nominee directors acting in the interest of all shareholders and the development and implementation of rigorous institution-building plans all help address deficiencies identified in the course of the Bank's due diligence.

Notes

[1] This publication was released in 1997 and can be found on the Bank's web site: www.ebrd.com/pubs/legal/4758.

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Corporate governance codes and their implementation

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The corporate governance codes in European countries vary considerably in terms of content, legal status and origin. This article discusses the types of codes which have developed, the "comply or explain" principle and the enforcement of the codes.

Good governance – both by public institutions and by private business – is considered one of the building blocks upon which economic success is based. The efforts undertaken by many international[1] and national organisations and bodies to improve governance, especially by enacting rules, standards or recommendations, should be respected and serve as models against which directors of these institutions or companies can measure their conduct.

Corporate governance is a subject that is notoriously difficult to define in one sentence. Some view corporate governance in the narrow sense, dealing with the structure and functioning of the boards of directors, and their relationship to management. This narrow definition is the one often found in corporate governance codes. A broader definition includes a company's relationships with shareholders, especially in organisations with concentrated ownership. Finally, academic studies dealing with governance broaden the definition to all internal relationships within a business, including the issues raised by the conduct of shareholders, especially institutional investors, the functioning of the general meeting and the company's relationship with the financial markets.

As this article relates to the implementation of corporate governance codes and not to their substance, the narrow definition will be followed.[2]

Regulating corporate governance

Company law versus governance codes

Rules relating to corporate governance are usually mixed in nature: the basic rules are laid down in statutory instruments, usually company laws. Legislation covering more complex topics, like the rules on takeover bids, also contain crucially important elements of corporate governance.[3] Securities regulation contains the basis for the disclosure rules, which are often used for enforcing corporate governance codes.

In addition to the statutory rules, governance rules and practices are often imposed by the stock exchange on which the shares of the company are traded. The articles of association of the company, as well as the internal rules of the board of directors, may also contain governance provisions. Traditions and good practice in a given jurisdiction should also be mentioned.

Recently, there has been a move to streamline and coordinate these more informal sources of corporate governance into codes.[4] These codes should not be considered equivalent to law or contractual provisions relating to governance.

A short typology of corporate governance codes

Looking at the different codes that have been drawn up in Europe, it is clear that these vary considerably in terms of content, legal status and origin. (See Table 1 for a summary of the codes adopted in the new European Union member states.) In addition, their implementation is often founded on different techniques. As to their scope, corporate governance codes mostly relate to listed companies only.[5] As to the origin and legal status of the codes, several models can be distinguished.

Codes which developed as private initiatives often originated from academia[6] or from a leading association of business firms.[7] These "recommendations" essentially have a mere moral value, presenting the way governance should be dealt with, but without any technically binding force. This does not mean, however, that these

Codes introduce significant flexibility into the governance system and allow companies to take account of their individual situations. Codes are an incentive for companies to grow towards better governance practices, without having to revolutionise their internal structures and procedures.

instruments have no value: they serve as an example to the business community, and violation of its precepts would be stigmatised as a violation of the code. Strikingly, the "comply or explain" technique is usually not found in this type of governance recommendation. One could qualify this model as voluntary.

The second type of governance code is directly linked with the securities markets. In a mild form, these codes have been drawn up under the aegis of the stock exchange,[8] or by a committee mandated by the exchange. In the stronger form, the codes are mentioned as a listing condition, allowing the exchange to refuse non-complying companies. It does not necessarily, however, allow it to impose provisions on already listed companies. In this instance, non-compliant companies have to explain the reasons for non-compliance.

The third type of code is linked with the public authorities. This link is very diverse: in some cases the initiative to draw up the code was made with the participation of the ministries of finance or justice. In other cases, the drafting committee was appointed by the ministry, or with its participation, or sometimes also with that of the market supervisor. Although this type of code has no legal standing on its own, it draws its authority from the support of the public authorities and the quality of its draftsmen. Publication in the official journal contributes to the authority of the code, but does not change its legal standing as a non-mandatory instrument.[9]

In a further model, a more explicit link is established with the legislation. In Germany and in the Netherlands, company law contains an express reference to the governance code, whereby companies are legally obliged to adhere to the code, and can only derogate by stating their reasons. The business community, especially the institutional investors, attach importance to these codes. They help investors assess the issuer's shares, and hence their willingness to invest in these shares. This type of code is sometimes referred to as self-regulatory, but the term is rather ambiguous, as the degree of involvement of the regulated firms varies.

The final type of code is referred to in law and supervised by a government body, more specifically the securities market supervisor. Although the practice is not clear, this seems to be the approach followed in Spain. Depending on the way the supervision is exercised, it may come close to traditional statutory law. The full statutory approach is the one followed in the US with the Sarbanes-Oxley Act. The rigidity of this regulation has often been regretted.

The dividing line between soft regulation and hard law is a shifting one. There is a relatively large variety: in the original European Union (EU) member states, codes focus on the functioning of the board, leaving company law questions aside. In the new member states, the codes broaden to issues of company law in general.

Most of the time, countries have "advancing juridification", whereby the principle is laid down in the law, while the detailed rules of functioning are left to internal, soft laws. Independent directors and audit committees, for example, are recommended in most codes. The former have been the subject of an EU recommendation, while the principle of having an audit committee or a similar function is laid down in the fourth company law directive. Further details are left to the companies themselves.

Comply or explain

One of the essential differences between corporate governance codes and traditional company law is that even if the code is binding as a requirement – which is rarely the case – it is not binding as to substance. This feature lies at the basis of the famous "comply or explain" principle.[10] Firms subject to the code are invited or obliged to adhere to the code: in practice, they cannot "just say no". However, they are not bound to follow the provisions of the code on any given item.

If a company deems it preferable to set aside a specific provision of the code, it may do so provided they state their reasons. This is the "explain" alternative. According to the "comply" principle, by stating the objectives that a company wants to achieve, codes introduce significant flexibility in the system, and allow them to take account of the myriad of individual situations.

Codes are an incentive for companies to grow towards better governance practices, without having to revolutionise their internal structures and procedures. This dynamic function should not be underestimated: often it is said that corporate governance is more about method, than about substance.

"Comply or explain" has one obvious drawback. If a company is free to set aside provisions of the code, provided they publish some sort of explanation, how can we be certain this explanation is true and reliable? Will companies be able to shirk from the detailed requirements of the code by giving a general explanation? In other words, should codes be made legally mandatory and should the truth of explanations be verified?

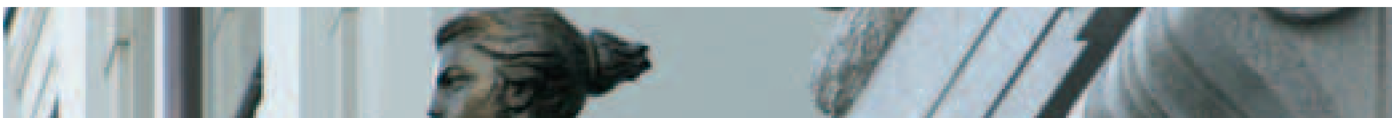
The role of disclosure

In most corporate governance codes, disclosure plays a central role: companies disclose, in their annual report, how they deal with corporate governance issues. This information should conform to the code's provisions. Disclosure therefore is a key element in all code driven governance systems, while conversely markets will strongly influence the governance practices.

Enforcing corporate governance codes

As almost all existing corporate governance codes are of a non-statutory nature, their binding force cannot be based on the usual legal techniques, for example liabilities, injunctions, fines, imprisonment. Generally soft law rules have to rely on the voluntary behaviour of their addressees. However, although voluntary in essence, this does not mean there are no strong incentives for companies to comply with the codes. The sanctions are essentially economical or financial, not legal. The extent to which these incentives ensure effective implementation of the codes is often doubted, but difficult to affirm or deny for lack of empirical data.

In many jurisdictions, there are sophisticated data about the formal implementation of the code's provisions. This data include the number of companies which have designated independent directors or appointed audit committees. However, whether these directors are effectively independent, or whether the audit committee adequately performs the tasks expected of it, is much more difficult to verify.



It is initially the responsibility of the board of directors to ensure that – within the applicable legal framework – the company's corporate governance is well balanced and in accordance with the code.

In some EU member states the debate has taken a political turn with the legislator requiring that the code be formally adopted. In others, there have been discussions as to whether the securities supervisor should be involved. Only in Spain, the securities commission is mandated to check compliance with the code.

There are numerous instruments and techniques that support the voluntary implementation of corporate governance rules. Most of these create incentives for companies to abide by the code's provisions. Market pressure and the fear of reputational damage often suffice for business leaders to adhere to the code.

Although not part of the law, corporate governance codes do not function in a legal vacuum. The relationship with the existing legal system needs to be clarified. In some EU member states, a formal link with company law has been introduced. The extent to which these obligations can be supervised by securities supervisors has also been examined.

Incentives for complying with corporate governance codes

Accountability of the board

It is initially the responsibility of the board of directors to ensure that – within the applicable legal framework – the company's corporate governance is well balanced and in accordance with the code. The board should also pay sufficient attention to its own functioning and evaluate its governance by introducing mechanisms that ensure these objectives. Such mechanisms include self assessment, appointing a separate corporate governance committee or calling on external expertise.

The board should report on its governance. This "governance statement" is set to become mandatory by European Directive. Disclosing the report increases the board's external responsibility to both shareholders and to the market in general. Apart from reputational risk, directors may become civilly liable if the statement contains untrue facts, or is likely to mislead. It may also trigger the intervention of the securities supervisor.

The extent to which shareholders should be involved in producing the governance statement differs considerably between codes. In most codes, shareholders are informed about the governance statement, but do not approve it, at least not formally. The supervisory board – but not the general meeting – usually approves the statement. However, shareholders are more directly involved, for example, in the election of independent directors to the board at the general meeting.

Involvement of shareholders in the corporate governance statement is usually considered interference in the board's functioning. It is also seen as incompatible with the structural model of the company. However, boards can be fired if the general meeting considers the statement – different from the actual governance practices – unsatisfactory. The statement can have a negative influence on the share price.

Involvement of the auditor in verifying the corporate governance statement is controversial. In many jurisdictions, the auditor has intimate knowledge of the company's functioning. In some EU member states, an auditor's intervention is considered part of the verification process, leading to the annual accounts and report. In others, it is stated that the auditor should limit its role to verifying the figures that are mentioned in the governance report. Intervention can only be formal and confirm whether the required disclosures are made in accordance with the provisions of the code, but not whether the information is true or accurate.

Market assessment

By imposing disclosure, the codes expose a company and its board to justification, outside criticism and most importantly to market assessment. In general, board members can be expected to protect their reputational capital and will voluntarily adhere to good governance practices, even in the absence of formal codes. The media has become more alert to these issues and regularly expose blatant shortcomings.

Pressure from peers should not be underestimated, as weak governance practices on one board may spill over to damage the reputation of other boards. More important, however, is the pressure of the markets. This includes all actors intervening in the capital markets: stock exchanges, rating agencies, investment bankers, organisations, activist investors and their advisers, the media and the public.[11]

The most direct impact of weak governance practices is on the company's rating. Rating agencies have recently begun including governance in their rating criteria and are developing specialised ratings specifically addressing a company's governance. Investment bankers, consultants and lawyers in general advocate compliance with the applicable governance code. These professional parties will not jeopardise their highly valued reputations by associating with companies with poor corporate governance.

The effect of good governance on price formation is controversial in the sense that it is empirically difficult to prove that good governance has a positive impact on share price. It is much more evident, however, that "bad" governance has a negative impact, undermining the market's confidence in a company.[12] In the same sense, the publication of incomplete, or worse untrue, facts in the governance report is likely to severely damage a company's reputation, and affect its share price.

The impact of institutional investors should also be mentioned. These investors are often obliged to vote at the general meeting and take a public stand on governance issues. Institutional investors will hesitate to acquire shares in issuers whose practices do not abide by usual governance standards. When some issues are voted on – for example, measures entrenching management – these investors will generally instruct a proxy organisation to vote against the proposals. At present, European investors have yet to employ the abrasive techniques practised by US institutionals in putting the worst governed companies on a black list. That being said, institutionals in Europe are increasingly putting boards under pressure regarding governance issues.

Often corporate governance codes are linked to the stock exchange. The exchange has a clear interest in ensuring companies it has admitted for trading comply with good governance standards and hence deserve their high quality label. As a result, governance conditions are often found in listing rules.[13] Upon access, the exchange will usually be able to enforce these rules. To maintain abeyance to the rules, or to impose them on already listed companies, is more difficult.

Apart from "name and shame", the exchange could delist the company's shares. In practice, however, delisting is not an option due to the damage it may inflict on investors. Therefore some exchanges follow a softer approach and motivate companies to adhere to its code. Some even organise education and training of directors and investor relation specialists.[14] Here the carrot will win over the stick.

External monitoring and review

In some instances, external monitoring may document the degree of implementation. Comparative reports on monitoring illustrate good practice and stimulate other companies to adopt similar conduct. Here again peer pressure and pressure from the media is important. This monitoring is undertaken spontaneously, for example by academics,[15] by associations of listed companies[16] or by consultancy firms.[17]

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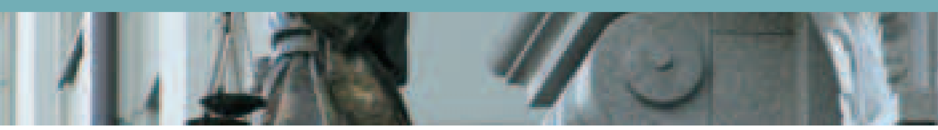
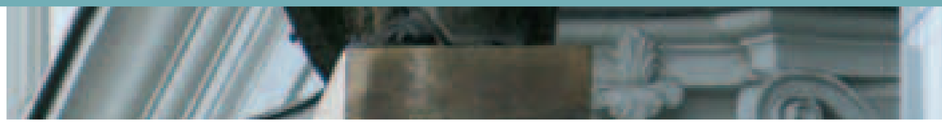


In the new EU member states, considerable attention has been paid to the subject of corporate governance. In most states, elaborate codes have been produced, mainly under the aegis of the stock exchange and often with strong support of the public authorities.



In some EU member states, the monitoring is undertaken by essentially an official body. The role of these committees is not to verify the compliance by individual companies, but to screen the overall practice in a given jurisdiction. The committee publishes its assessment, usually anonymously. It can also recommend changes to the code. This type of monitoring committee has been introduced in France,[18] in the Netherlands, in Switzerland and in a different form, in the UK.[19]

It is unlikely a monitoring committee would use the "name and shame" technique with respect to companies that refuse to comply with the code. The rules on libel or slander would most of the time prevent this approach. Official review panels could take a stronger stand, provided the publication of names be allowed by the law.

Little analysis has been undertaken on the use of governance criteria in connection with loan conditions. Sometimes the loan documentation will contain explicit clauses that can be classified under the governance heading. This includes requirements relating to the number of independent directors on the board or the existence of a formal audit committee. These covenants may therefore be considered as another monitoring device.

The effectiveness of these enforcement instruments cannot be clearly established. While the empirical studies indicate whether the separate provisions of the codes have been addressed, they do not yield reliable information as to the substance of implementation. If implementation has been formally compliant, but is substantively unsatisfactory, ultimately only the board of directors would be able to identify the shortcomings and to impose corrective action.

Legal rules specifically ensuring compliance with corporate governance codes

Although corporate governance codes generally are not legally binding, being either voluntary or self-regulatory, there is little doubt that they have legal relevance. In case law, judges are likely to make reference to the codes when looking for guidance. It prevents judges from having to determine themselves what is widely accepted business behaviour or "good practice".

Outside the field of liability of directors, the same criterion might also be used, for example to apply remedies related to wrongful trading, or according to some laws, to decide upon a judicial enquiry.[20] This phenomenon of absorption of soft law rules by the legal system has been witnessed in several fields. It acts as a technique for filling in blank norms in the legal system.

"Good faith", liability for violating the duty of care and general principles like the Dutch "reasonable and equitable conduct" *(redelijkheid en billijkheid)* are the usual entry points through which the legal order absorbs elements drawn from soft law. These elements include professional "conduct of business" rules, "state-of-the-art" techniques, model contracts and other rules grown out of business practice. Now that the corporate governance rules have been written down, "codified" and are supported by leading businessmen, by the stock exchanges and the securities commissions, it is obvious that judges will refer to them rather than apply rules of their own determination.

In both Germany and the Netherlands, company law contains an express provision which states listed companies must publish an annual declaration, making express reference to the corporate governance code. Companies must declare that they have respected the code, while indicating which recommendations have not been followed. Both systems adhere to the "comply or explain" philosophy, and do not declare the substantive rules of the code applicable at law.

Companies that do not adhere to the codes would hence violate company law and face the sanctions provided under that law.[21] Companies might, however, simply state that they adhere to the code without giving any further information. The information should not be untrue or false, as this would trigger the liability of the members of these bodies. However with respect to the substance of the information, company law contains no express provision: this is the sole responsibility of the board. The Dutch corporate governance code – but not the company law – states that the governance statement should be submitted to the general meeting and that significant changes should be discussed.

A difficult question relates to the consequences of deficient corporate governance statements. When a board adheres to the code and publishes reasons for not complying, the motivation disclosed may be deficient in several respects. This could be because the disclosed reason may be futile, or too general, it may be untrue or incomplete, or the information may be misleading or even false.

If the information the company publishes merely amounts to a formal explanation, but is intrinsically insufficient to justify its non-compliance with the code,

Table 1 Corporate governance codes in new EU member states

	Name of the code	Date of issuance/ latest amendments	Drafting authority
Czech Republic	Corporate Governance Code (based on the OECD Principles of Corporate Governance 2004)[I]	Approved in June 2004	Drafted by an expert group, composed of representatives from the Securities Commission, Prague Stock Exchange, auditing companies, professional associations and some listed companies.
Estonia	Corporate Governance Recommendations[II]	Approved on 14 September 2005 (entered into force January 2006)	Drafted by the Tallinn Stock Exchange (TSE) and the Estonian Financial Service Authority (FSA).
Hungary	Corporate Governance Recommendations[III]	Approved on 8 December 2003	Drafted by the Board of Directors of the Budapest Stock Exchange (BSE), in cooperation with Ernst and Young. Each draft was discussed with a review committee comprising market experts and issuers. The final version was approved by theBoard of Directors of the BSE.
Latvia	Corporate Governance Principles and Recommendations on their Implementation[IV]	Approved on 21 December 2005 (entered into force on 1 January 2006)	The Principles were an initiative of the Riga Stock Exchange (RSE). Comments from a large number of shareholders were considered during the drafting.
Lithuania	The Corporate Governance Code for companies listed on the Vilnius Stock Exchange[V]	Approved on 23 April 2004	Drafted by the Vilnius Stock Exchange and approved by the Securities Commission.
Poland	Best Practices in Public Companies 2005[VI]	Approved on 15 December 2005	Prepared by the Best Practices Committee at the Corporate Governance Forum.
Slovak Republic	Corporate Governance Code[VII]	Approved in September 2002	Drafted by the Bratislava Stock Exchange (BSE) in close cooperation with the Financial Market Authority, INEKO and professional associates under the British-Slovak Action Plan.
Slovenia	Corporate Governance Code[VIII]	March 2004 (first consolidated version), amended in December 2005	Drafted by the Ljubljana Stock Exchange, the Managers' Association and the Association of the Supervisory Board Members.

No Yes

Source: EBRD 2006.

Notes:

I See http://www.sec.cz/export/EN/Publications/get_dms_file.do?FileId=1253.

II See http://www.fi.ee/failid/HYT_eng.pdf.

III See http://www.bse.hu/gfx/download.arg?ptype=FILE&id=10002821&uio=4LONGLROTVJZ2006T01N19JF13Z07302N9Y8ENW05guest.

IV See http://www.lv.omxgroup.com/docs/CorporeteGovernance_20060101_ENG.pdf.

V See http://www.lt.omxgroup.com/f/teisesaktai/Corporate%20governance%20code.pdf.

VI See http://www.gpw.com.pl/zrodla/gpw/pdf/Best2005.pdf. Also see the article "The past, the present and the future of corporate governance in Polish listed companies" in this issue of *Law in transition*.

VII See http://www.cecga.org/files/CorporateGoveranceCodeAJ.pdf.

VIII See http://www.ljse.si/cgi-bin/jve.cgi?doc=1361&sid=yrTbTmIV43qLFxLo.

Adopted by the stock exchange	Compliance requirements	Comply or explain principle	Supervision of compliance
■	None. Compliance with the Code is not mandatory.	■	None
■	The Recommendations are included in the listing rules of the TSE. Issuers have to meet the requirements of the FSA regulations and publish their corporate governance report according to TSE requirements.	■	Formal
■ The Corporate Governance Board was established in November 2004 as an official committee of the BSE.	The Recommendations are included in the listing rules. of the BSE. Compliance statements are mandatory for issuers whose shares are listed in the “Equities A” and “Equities B” categories of the BSE. Compliance become mandatory for these categories from 30 April 2005 and 30 April 2006 respectively.	■	Formal
■	Listed companies will be required to issue a compliance statement in 2007 along with an annual report.	■	Formal, but the RSE can request the securities regulator clarify whether the provided statement is true.
■	The Code currently serves only as a recommendation. An amendment to the Law on the Securities Market, currently being debated, provides that the Code will become mandatory for listed companies. A new version of the Code is under discussion. The new Code will contain amandatory “comply or explain” rule.	■	Currently none. Formal supervision is to be introduced in 2006.
■	The Practices are included in the listing rules of the Warsaw Stock Exchange (WSE).	■	Formal
■	The Code is included in the listing rules of the BSE.	■	Formal
■	The new Ljubljana Stock Exchange Rules require listed companies to publish a declaration of compliance with the Code.	■	Formal

there is no direct sanction applicable. However, if the information is mandated by other provisions, for example company law or published according to a financial regulation, there may be a sanction (see, for example, the obligation to publish price-sensitive information).[22] When untrue, incomplete or even misleading information is published, the rules on board liability for disclosure usually apply.[23]

In some jurisdictions, the question has been debated to what extent a securities supervisor should be involved in monitoring the implementation of the corporate governance codes. Indeed securities supervisors have privileged contact with listed companies. They already review some of the company’s disclosures. As the governance statements often form part of the annual reports, it seems logical to charge securities supervisors with this competence.

Some jurisdictions, especially the Netherlands, believe the securities supervisor should only be involved in checking that the corporate governance statement conforms with the code. The supervisor should not be involved in checking the content. The content should be entirely left to the board of directors who are in charge and take responsibility for running the company.

Making governance codes part of the law should be avoided as it eliminates the flexibility originally intended. The role of the external monitors – securities commissions, review panels, etc – should remain defined within the limits of "external review". This would not prevent the securities supervisors from exercising their other legal competences, for example verifying whether the factual elements in the annual report – such as directors' remuneration – are true. This check would occur irrespective of whether these elements are part of the corporate governance statement or not.

In one jurisdiction (Spain), the securities supervisor is set to be in charge of verifying whether the governance statement conforms with the law, for example, whether the legal criteria for deeming a director independent has effectively been respected. It is unclear what the results of this approach will be.

Writing the governance rules into the law destroys the typical advantages of the soft law codes: adaptability and flexibility to develop better solutions. However, with respect to specific items, if it appears that the code provisions have not been effective, and that the business community refuses to abide by it, the law should step in. This is the lesson drawn from the German experience. The refusal by a large part of the business community to publish data on directors' remuneration has led to a formal law, imposing such disclosure.

Corporate governance codes in central Europe

In the new EU member states considerable attention has been paid to the subject of corporate governance. In most states elaborate codes have been produced, mainly under the aegis of the stock exchange and often with strong support of the public authorities.

The explanation for this strong interest can be found in factors that are linked to the transition phase of their economies.

Stock exchanges need codes to support the reputation of their listed shares. Codes are needed as part of the drive of local boards and management to adhere to good practice. The presence of controlling shareholders, and especially of the state, require countervailing forces. In other cases, the codes are expected to supplement company law.

The effectiveness of the codes is difficult to assess. Critical voices[24] have stated that the codes do not efficiently deal with the dominant influence of major shareholders, including the state. A similar observation was made in the original EU member states, in the early years after the codes were enacted. There the criticism has subsided as pressure of the independent media, international investors and their supporting organisations, and in critical cases, from an active securities supervisor has been quite powerful. The influence of the state remains a specific concern, particularly the negative share premium which exists due to state participation. Here too, the code at least serves as a reference point.

Amendments to the company law directives

Recently the EU adopted a proposal to amend the fourth and seventh company law directives. These amendments stated that listed companies should publish a corporate governance statement, whether as part of their annual reports or in a separate report.[25] The statement should include:

- a reference to the mandatory corporate governance code; however a reference to a voluntary code may be allowed by company law. In addition, the statement should contain "all necessary information about the corporate governance practices applied beyond the requirements under national law"
- the "comply or explain rule" for departures from the corporate governance code: this relates not only to specific provisions but to the code as a whole
- further information on internal controls and risk management systems.

The directive further calls for members of the board to be liable for the corporate governance statement. It states that there should be penalties for infringing the implementation of national provisions. Administrative sanctioning is not mentioned, but is likely to constitute an effective enforcement instrument, provided it is clarified who will be entitled to impose the fines.

Conclusion

The enforcement of corporate governance codes is a complex matter. Compliance is insured first and foremost by internal mechanisms: the board of directors and the management, under the overall guidance of the shareholders, have to take responsibility for applying the code. The market will provide the environment in which developments will thrive.

Outside monitoring – the auditor, the supervisor, the regulated market or a review panel – may also be envisaged. However, their remit is generally restricted to formal assessment. Judicial enforcement is not generally favoured as seen by existing statutory governance rules.

As stated by the European Corporate Governance Forum, the role of shareholders and of the general meeting deserve to be strengthened. This will contribute to better management of the company and accountability of the board. By establishing a stronger link between market-led enforcement and internal governance instruments, the overall governance system is likely to be strengthened. This will be more successful than imposing formal legal or administrative requirements. Inspiration can be sought in the recent initiatives of the European Commission on shareholder rights.[26]

Notes

[1] OECD Principles of Corporate Governance 2004: http://www.oecd.org/dataoecd/32/18/31557724.pdf. The OECD principles have served as a direct and explicitly mentioned source for some of the national codes, for example, the Czech Corporate Governance Code 2004: http://www.sec.cz/export/EN¬/Publications/get_dms_file.do?FileId=1253.

[2] See also E Wymeersch (2006), “Enforcing Corporate Governance Codes”, ECGI – Law Working Paper No. 46/2005, Social Science Research Network and Journal of Corporate Law Studies: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=759364.

[3] For example, Articles 9 and 11 of the Takeover Directive, 2004/25 of 21 April 2004, OJ L 142/12 of 30 April 2004.

[4] Most of the codes released worldwide can be found on the web site of the European Corporate Governance Institute: http://www.ecgi.org/codes/all_codes.php.

[5] There are codes addressed to unlisted, especially family owned companies, for example the so-called Buysse Code in Belgium: http://www.unizo.be/images/res109906_5.pdf. In addition, some codes make reference to unlisted companies to which the principles of the code is declared of use, for example the Czech Corporate Governance Code.

[6] In Germany a group of academics published the first corporate governance code: Corporate Governance Grundssätze, a Frankfurt Initiative, *Der Betrieb* 2000, 238 and Berliner Initiativkreis, *Der Betrieb*, 2000, 1573.

[7] Deutscher Corporate Governance Codex in Hommelhoff, Hopt von Werder (Eds), *Handbuch Corporate Governance*, 737. See for example, the Principles for Corporate Governance, October 2003, amalgamating the 1995 and 1999 Viénot and 2002 Bouton Reports containing recommendations for the French and Swiss codes.

[8] See the 2004 Corporate Governance Recommendations prepared by the Budapest Stock Exchange: http://www.bse.hu/gfx/download.arg?ptype=FILE&id=10013558&uio=4LONG1GAN3B42006801J127Z20I31326KBX6SEZ05guest. In the Slovak Republic the 2002 Code is the product of a cooperation between the stock exchange and the associations of company directors and managers: http://www.cecga.org/core.php?sid=0&lang=2&f=pages&p=showpage&s=docs

[9] This is the case for the Slovenian code: http://www.ljse.si/cgi-bin/jve.cgi?att=3313&sid=. Also the German code was published in the official gazette, but the reference is part of the German Companies Act.

[10] The principle is expressly mentioned in the Belgian, Hungarian and Polish codes. It is part of the companies act in Germany and in the Netherlands.

[11] This is the case for the Belgian, French, Italian, Swedish and Swiss codes.

[12] A positive correlation is shown in P Coombes and M Watson (2000), “Three surveys on corporate governance”, *The McKinsey Quarterly*, Issue 4, p. 74 and E Nowak, R Rott and T G Mahr (2005), “Wer den Kodex nicht einhält, den bestraft der Kapitalmarkt?”, *Zeitschrift für Unternehmens und Gesellschaftsrecht*, ZGR 252. The largely non-existent effect of the Sarbanes-Oxley Act, however, was shown in R Romano, “The Sarbanes-Oxley Act and the making of quack corporate governance”, NYU, Law and Econ Research Paper 04-032: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=596101.

[13] This is the case with the Corporate Governance Recommendations of the Budapest Stock Exchange and the Slovak Corporate Governance Code. In the UK, the governance codes are part of the listing conditions and include important rules dealing with, among others, significant and controlling shareholders and conflicts of interest.

[14] See the Polish Code: http://www.gpw.com.pl/zrodla/gpw/pdf/Best2005.pdf.

[15] See A von Werder (2005), “Die Akkeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex”, *Der Betrieb*, 841.

[16] See Assonime, Analisi delle stato di attuazione del Codice di Autodisciplina delle società quotate (Anno 2005), study 25, December 2005: http://www2.assonime.it:81/assonime/corpgov/ca.nsf/103/BCF1B71A987DC34FC12570DD005E68B4/$File/testo+e+appendice+analisi+2005.pdf?OpenElement.

[17] See Deminor: http://www.deminor.be/articles.do?id=3491.

[18] For France: *Rapport de l'AMF sur le gouvernement d'entreprise et les procédures de contrôle interne*, 13 January 2005, Revue AMF: http://www.cbfa.be/nl/publications/stu/stu.asp.

[19] The Financial Reporting Council, an independent regulator for corporate reporting and governance, was created on 1 April 2004. It acts in the field of corporate governance without an explicit statutory base, although reference is made to the rules on listing on the exchange, which require compliance with the code.

[20] On the basis of Article 2:345 of the Dutch civil code, the court can mandate an investigation (*enquête*) about the management and state of affairs (*beleid en gang van zaken*) of any company, allowing the court to take measures in case of mismanagement (*wanbeleid*).

[21] It runs contrary to the law if the board “just said no”.

[22] See Article 6 of the Market Abuse Directive 2003/6 of 28 January 2003, OJ L 96/16 of 12 April 2003.

[23] For an extensive study of these subjects, see Hopt and Voigt (eds) (2005), *Prospekt-und Kapitalmarktinformationshaftung*, Mohr Siebeck, Tübingen.

[24] N Cankar (2005), “Transition economies and corporate governance codes: can self-regulation of corporate governance really work?”, JCLS 285.

[25] See proposed Article 46 a, compromise proposal dated 22 April 2005: http://www.focusifrs.com/content/FichiersFocusIfrs/ACTUALITE/actu_divers/Propos_modif_4-7_directive_04-2005.pdf

[26] See “Fostering an Appropriate Regime for Shareholders”, 13 May 2005, second consultation.

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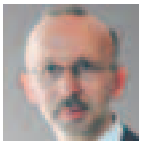
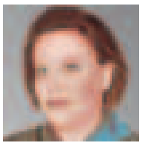
The past, present and future of corporate governance in Polish listed companies

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This article details the recent history of corporate governance in Poland, from the adoption of rules regulating public trading and the establishment of the Warsaw Stock Exchange to the implementation of corporate governance principles in listed companies.

The organisation and infrastructure of the Polish capital market is no different from mature global markets. The start of corporate governance legislation was marked by the adoption of the first legal act regulating the rules of public trading in securities and the establishment of the Warsaw Stock Exchange (WSE) and the Polish Securities Commission (now Polish Securities and Exchange Commission), respectively.

In less than a month after the Sejm (parliament) had adopted the Law on Public Trading in Securities and Trust Funds, on 12 April 1991, the Minister for Ownership Transformations and the Minister of Finance representing the Treasury signed the founding act of the WSE. Four days later on 16 April, the first trading session took place in which seven brokerage houses participated, trading shares of five companies. The Polish Securities Commission was appointed on 9 May 1991, and its first meeting took place on 3 June 1991.

Corporate governance and control

Since 1991 Poland has been developing high formal, as well as functional, trading standards and stimulating investment conditions. It should be acknowledged, however, that the rapid and spontaneous development of the Polish capital market in the mid-1990s failed to generate adequate and efficient forms of control. (This is in addition to the instruments that were made available by legislation and related statutory sanctions). Consequently, fundamental principles of corporate governance remained unobserved. This shortcoming was felt primarily by shareholders of listed companies and stakeholders of entities which planned to float their shares.

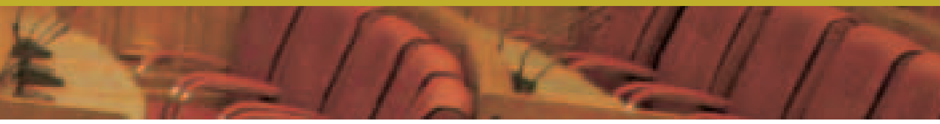
Not surprisingly interest in the principles of corporate governance, already strong in more mature global and European markets, reached Poland. The reasons for this growing interest in improving and implementing corporate practices were also behind increasing capital expansion. On one hand, they led to the rapid development of that market. On the other, they strengthened the need to initiate an efficient system of control and supervision. In addition, it led to the establishment of mechanisms for ensuring investors retained some control over the use of their capital, while being able to influence strategic decisions made by companies.

The Polish Corporate Governance Forum

The emergence of the first set of corporate governance standards both in Europe and the rest of the world coincided with the establishment of a functioning market economy and its primary institutions in Poland. However, as stated earlier, the very dynamic development of the Polish market did not allow for the formation of efficient forms of control, exercised by entities, providing the capital market with funds and directly stimulating its development.

Understanding that there was an urgent need to structure formally that area of economic activity, a group of people and institutions involved in the development of the capital market in Poland initiated

The Best Practice Committee consulted extensively with representatives from the financial community, academia and business when drafting the Polish standards of corporate governance.



a debate on the Polish model of corporate governance. At the beginning of 1999 that work resulted in the establishment of the Corporate Governance Forum, an arm of the Business Development Institute (Privatisation Centre Foundation).

The following entities actively participated in the functioning of the Forum from its inception:

- the Polish Securities and Exchange Commission
- the Warsaw Stock Exchange
- the Polish Confederation of Private Employers
- the Polish Business Council
- the Business Development Institute – Privatisation Centre Foundation.

Since 2000 the Forum has been cooperating with, among others, the World Bank, OECD, and from June 2002 the National Bank of Poland.

The work on developing best practices was also joined by the Issuer Association, the Association of Investment Fund Companies and the Chamber of Pension Funds. Such a diversity of entities not only ensured the comprehensiveness of discussions but also provided the Forum (and its work) with necessary community legitimacy.

The Best Practice Committee

As a result of the discussions held within the Forum, a group was selected to initiate the preparation of Polish corporate governance standards.
In May 2001 the mission to form the Best Practice Committee (BPC) was entrusted to the eminent commercial law expert Professor Grzegorz Domański, a practising lawyer and academic.

Professor Domański is one of the authors of the above-mentioned first legal act regulating public trading in securities.

The following eminent representatives of the business community also joined the committee:

- Henryka Bochniarz, President of the Polish Confederation of Private Employers
- Krzysztof A Lis, President of the Business Development Institute (deceased)
- Wiesław Rozłucki, President of the Warsaw Stock Exchange
- Jacek Socha, then Chairman of the Polish Securities and Exchange Commission
- Prof. Stanisław Sołtysiński, Sołtysiński, Kawecki & Szlęzak Doradcy Prawni law firm.

The BPC began the elaboration of the corporate governance principles for the Polish market by inviting representatives from institutions and companies operating in the Polish capital market to cooperate on an *ad hoc* basis.

Best Practices in Public Companies in 2002

In February 2002 the first complete set of Polish corporate governance standards was presented in a document entitled "Best Practices in Public Companies in 2002".

The final draft document was prepared in stages, preceded by extensive consultations with representatives of the financial market community, academia and business. The final document was the product of an extensive and diverse exchange which allowed committee members to express disparate views on individual issues. Many detailed principles contained in the document were, therefore, the result of compromise between a range of positions and opinions.

The document was divided into five general and 48 detailed sections. Its main part was structured to reflect the Polish Commercial Companies Code. Thus, the document was divided into:

- general rules
- best practices for general meetings
- best practices for supervisory boards
- best practices for management boards
- best practices in relation to third parties and third-party institutions.

It is also worth noting that this document was compiled with a focus on Polish business life and legal order. In many cases, bad practices identified and diagnosed were juxtaposed with best practices laid down in this document. Although international documents and discussions were closely analysed, the committee members were confident that the final document considered the specificity of the Polish situation rather than simply adopting international standards and solutions.

The corporate governance standards contained in the document were endorsed by the WSE supervisory and management boards in the autumn of 2002. At the same time appropriate amendments were made to exchange regulations.

Comply or explain

The implementation strategy adopted by the WSE and incorporated into its rules was based on the "comply or explain" principle. This method of implementing the best practice standards had two main advantages for companies:

- It facilitated observance of corporate governance principles.
- The method stimulated active involvement in governance processes not only by the management boards naturally interested in a company's efficiency and performance, but also by supervisory boards and general meetings.

A crucial requirement for the widespread implementation of the document, the development of corporate governance and the success of the Corporate Governance Forum and the BPC's entire project was the effective implementation of a governance dialogue with the companies themselves.

Members of the BPC, as well as the WSE, listened very carefully to that dialogue, and the conclusions that arose from it were transferred to the market.

Best Practices in Public Companies 2005

The 2002 document stated that it was "not a complete list … and should be constantly developed in line with the changing needs of the market". As a result, the committee decided to review and modify the set of rules and three years later released the "Best Practices in Public Companies 2005".

The 2005 document is the outcome of analyses and discussions, as well as extensive community consultations.

The amendments and modifications take into account practical experiences gathered, opinions and suggestions of market players and the latest recommendations of the European Commission.

Implementing the principles

When implementing corporate governance principles in Polish listed companies, it should be emphasised that the outcome of the process that commenced in 2002 has far surpassed expectations. The principles contained in the document became the subject of decisive critical reflection on the part of public companies. At the same time, companies made an effort to reorganise their corporate practice and establish an internal governance dialogue.

Since 2001 listed companies have been obliged to submit three declarations concerning observance of those rules. In July 2003 the WSE received the first declarations. A year later companies updated those declarations and in July 2005 companies submitted declarations relating to modified rules contained in "Best Practices in Public Companies 2005" (see Chart 1). Thus, it is now possible to make more in-depth comparisons and assessments.

Compared with the first declarations submitted by issuers in 2003, the extent of implementation of the principles contained in the 2002 document by listed companies increased in 2004 from 83 per cent to 90 per cent (see Chart 2).

In 2005, 247 companies declared implementation of at least one principle. In that group as many as 36 companies announced implementation of all principles. This represented a threefold increase from 2004. Furthermore, improvement with respect to the implementation of principle 20 concerning independent members of supervisory boards is particularly noticeable (see Chart 3).

Today as many as 60 issuers declare observance of that principle in its entirety, compared with 10 last year. The number of companies which had confirmed that they would not observe any of the principles decreased.

Independent directors

Considering these statistics, it is worth commenting on the reasons for such a low (though improving) degree of implementation of principle 20. As stated, principle 20 relates to the independence of members of the supervisory board and remains contested and controversial.

The debate about this principle, its implementation and the introduction of independent members to the supervisory body has been a global one. It is undoubtedly as heated in America as it is in Europe, including Poland.

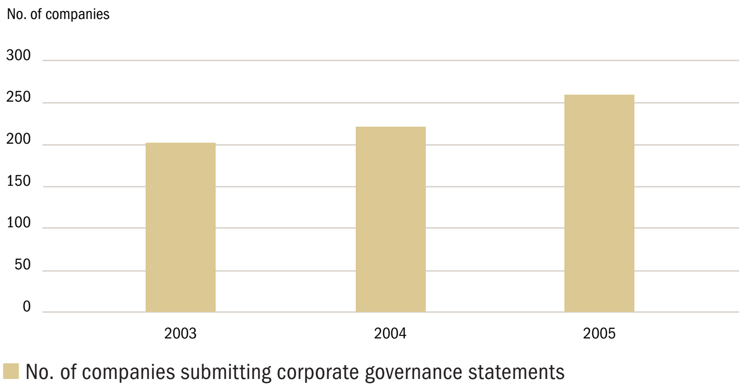
According to principle 20, at least half of the membership of the supervisory board should be independent. More specifically, members "should not have relations with the company and its shareholders or employees which could have a significant impact on the ability of the independent member to make impartial decisions".

The principle provides that detailed criteria of independence should be expressed in the company's statute. In addition, it identifies resolutions that should not be passed without the majority of independent members consenting.

Principle 20 was implemented later than the other principles (initially planned for the end of 2004 but revised to the end of June 2005). Until that date companies were not obliged to declare whether they observed the principle. Some of them

Polish companies have shown that they are willing to take the steps needed to improve corporate practices and, more importantly, are aware of the central role played by corporate governance in a company's operations.

Chart 1 Corporate goverance practices of companies listed on the Warsaw Stock Exchange



Note: In 2003, 99 per cent of companies listed on the Warsaw Stock Exchange had submitted corporate governance statements. In 2004 and 2005, this figure rose to 100 per cent.

Chart 2 Implementation of principles from "Best Practices in Public Companies in 2002"

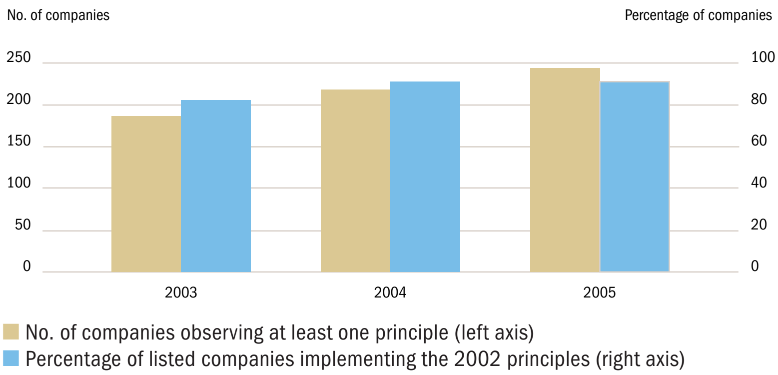
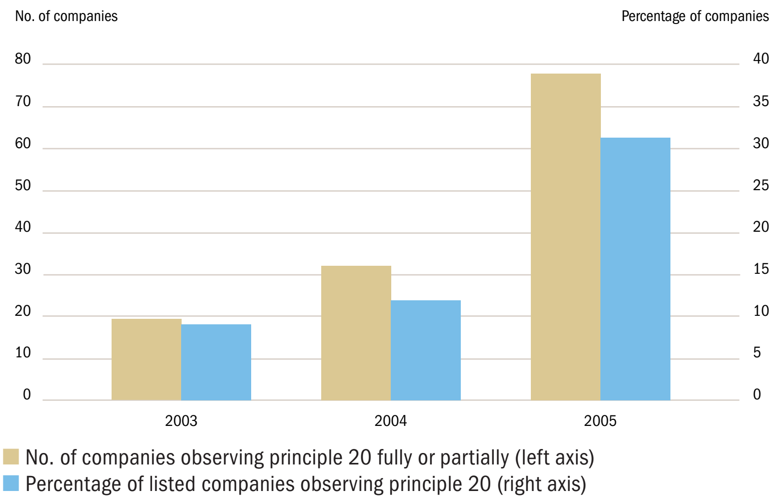


Chart 3 Companies with independent members on their supervisory boards



Note: Principle 20 of the "Best Practices in Public Companies" states that at least half of the membership of the supervisory board should be independent.

Source: Warsaw Stock Exchange.

decided, however, to introduce this requirement and – it should be emphasised – an independence criteria to their statutes.

Ongoing dialogue

It is worth noting that, while declaring their willingness to implement principle 20, many companies also indicated difficulties arising from the absence of a precise definition of independence. Particularly, these problems related to the requirements for obtaining that status. There was also a substantial group of issuers questioning the rationale or practicality of implementing principle 20 owing to the presence of a controlling (majority) shareholder in the company.

While amending the original document for 2005, the BPC decided to clarify the definition of independence. It has used the criteria specified in the European Commission's recommendation on the role of non-executive or supervisory directors and on the committees of the (supervisory) board. Requirements governing the number of independent members in a company's supervisory board were also lessened following objections from some companies and brought in line with international (especially US) markets. These applied to situations where more than 50 per cent of votes at the general meeting are held by one shareholder (or group).

Despite these efforts, declarations and comments by companies (available on the WSE web site) continue to reveal a lack of understanding of the substance and purpose of that principle. Some progress, however, is noticeable.

With a view to the above, the WSE will continue its intensive educational and promotional activities with regard to the implementation of principle 20. It is hoped that these efforts will produce the expected results.

Notwithstanding the problems concerning the implementation of principle 20, observance of corporate governance was attained much earlier in Poland than in many other developing markets where the process of acceptance has taken many years. Polish issuers were willing to take steps aimed at improving corporate practices in their companies and, more importantly, proved to be aware of the central role played by corporate governance in a company's operations.

It should be noted, however, that the high degree of implementation of the corporate governance principles was not always indicative of a thorough understanding of individual corporate principles by companies. This became evident through the numerous queries concerning the interpretation and practical application of these principles. The WSE supports all educational activities in this respect, while being involved in an ongoing dialogue with companies on that question.

The implementation of corporate governance principles is a complex and long-term process in which declarations submitted by companies constitute only the first stage. The experience of other markets and the nature of corporate governance regulations show that making a declaration does not automatically mean that it has been properly and correctly understood. Hence there is a need to conduct continuous dialogue with companies until the ultimate objective is attained – the conformity of a company's behaviour with the adopted principles.

An important and frequently raised issue is the extent and quality of information being disseminated throughout the market, as a result of the implementation of corporate governance principles. It should be stressed that all listed companies have fulfilled the new information requirement and filed declarations concerning observance of these principles.

Both shareholders and investors should be given a certain amount of information on the position of governing bodies within listed companies. An exception might be the declarations of certain issuers that do not fully reflect the substance of the "comply or explain" principle. Nevertheless, those declarations contain statements that do take into account the interests of all stakeholders.

The Polish Institute of Directors

As already noted, the WSE has appreciated the importance of both the Polish and international corporate governance movements. Since 2002 the WSE has been a member of the European Corporate Governance Institute. In 2003 the WSE also joined the group of signatories of the Agreement Establishing the Polish Institute of Directors (PID). PID was organisationally tied to the Business Development Institute, which provided the framework for the Corporate Governance Forum.

In 2005 the WSE was among the founders of the Polish Institute of Directors Foundation replacing the PID. The statutory goals of the PID Foundation include, among other things:

- promoting corporate governance principles in all communities that influence the economy and corporate behaviour
- supporting the implementation of best practices in public companies into corporate practice, as well as preparing, consulting and proposing changes in appropriate documents underlying this implementation
- stimulating public initiatives aimed at creating, promoting and assessing the application of corporate governance principles also by companies not listed on the WSE
- spreading the practice of appointing independent members of supervisory boards in capital companies and setting up supervisory board committees.

Still a lot to be done

As shown in this article, the WSE tries to support not only educational initiatives but also those promoting the corporate governance movement. In order to attract domestic and foreign investors, solid corporate governance has to be present in Polish public companies. It is hoped capital will stay through, among other things, improving the competitiveness of Polish companies and protecting the interests of all investor groups.

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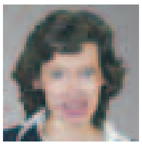
Corporate governance practices in Russia and the implementation of the Corporate Governance Code

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Corporate governance practices in Russia are gradually improving following the development of the Corporate Governance Code and the introduction of new legislation. Whilst standards in publicly listed companies have improved, several weaknesses in the legislation and its application remain.

In 2002 Russia introduced a Corporate Governance Code. While the Code has the potential for boosting good corporate governance in the country, its application and monitoring mechanisms have had somewhat of a limited effect on Russian companies. New regulatory initiatives have made several of its provisions binding for listed companies since January 2006, but the effectiveness of these regulatory changes in fostering governance practices remains uncertain. This is due to the limited number of companies affected, as well as the remaining weaknesses in the Russian legislation and the judicial system.

Legal infrastructure of corporate governance in Russia

In recent years, a number of initiatives brought forward by legislators and representatives of the Russian and international financial community have produced a body of laws designed to give more protection to minority shareholders. Public interest in the Russian corporate wars of the late 1990s, the activities of international organisations (such as the EBRD, the OECD, the World Bank Group and TACIS), and local investment professionals have all helped highlight the weaknesses of Russian law. These and other efforts have led to the tightening up of many loopholes. As a consequence, cases of gross abuse of shareholder rights, common in the 1990s, have become largely a thing of the past.

Unfortunately, the effectiveness of Russian legislation and the judicial system in upholding corporate governance practices remains weak, hampered by a lack of enforceability, opacity of beneficial ownership, concentrated ownership structures and the prevailing influence of the Russian government in state-owned entities.

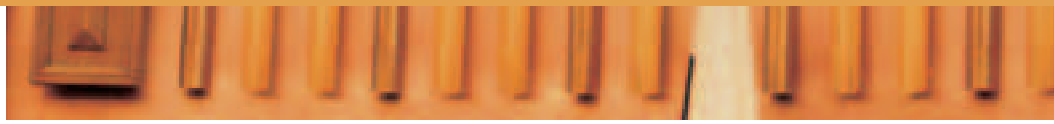
The Russian governance infrastructure includes a fairly explicit definition of shareholders' rights (including the principle of one share-one vote and clear guidelines for shareholder meeting procedures). In addition, there are traditions of socially responsible behaviour particularly in the older, privatised companies which play an important role in the life of local communities. However, the legal system continues to suffer from a lack of effectiveness and fails to provide adequate support to strong corporate governance practices.

One of the key problems is the highly literalistic approach Russian judges have to interpreting the law. Although many provisions of the law follow positive international practice, they are often narrowly defined. This makes it possible to enforce the letter of law but not its spirit. For example, application of the very restrictive definition of related parties allows many related-party transactions to "fall through the cracks" and avoid required corporate approval procedures. This can lead to various abuses of shareholder rights despite, in theory, adequate legislation.

Other examples of abuse of the legal system include:

- political connections being used as a prime weapon in hostile takeovers
- unlawfully engaging police and other law enforcement agencies in corporate conflicts
- questionable verdicts of judges, especially when state or major business interests are involved.

The effectiveness of Russian legislation and the judicial system in upholding corporate governance practices remains weak, hampered by a lack of enforceability, opaque ownership structures and the prevailing influence of the Russian government over state-owned entities.



As a result, investor confidence in the Russian court system remains low according to a Standard & Poor's Ratings Services investor survey in 2003.

All participating investors in the survey encountered problems in their activities as shareholders. Only 20 per cent went to court to defend their rights and of these only a few managed to win their cases. Investors generally avoid the courts because of their low efficiency. This includes long periods for trials, a reputation for corruption and limited opportunity to enforce a court's decision.

The problems of the weak legal system are due to both the complex structural organisation of the courts and their lack of independence. (This is in addition to weak enforcement and accountability mechanisms.) Low effectiveness of the legal system is a constant focus of public criticism. In response to this criticism, the government has given repeated promises to address these problems by launching administrative and judicial reforms. As yet, however, no reform has proved successful or achieved the ultimate goal of enhancing the effectiveness of the law.

One of the weak areas hampering law enforcement, and therefore having a negative effect on corporate governance, is ownership disclosure. Only 28 per cent of the total private ownership of Russia's 54 largest public companies was disclosed as of September 2005.[1] For banks, the figure is even lower: only 16 per cent of aggregate private stakes of the 30 largest Russian banks have disclosed their owners.[2] The disclosure levels are expected to be lower again in second-tier companies and those not listed. Consequently, when listed companies are entering commercial transactions with their smaller private counterparts, it is common that the owners of both parties to the transaction (that is, the end beneficiaries) are not easily identifiable.

In developed countries, transparency of ownership is aided by legislation requiring shareholders to report all beneficially owned stakes above a certain threshold. Depending on legislation, this obligation is either enforced by regulators, or supported by the company's right to deny voting rights to non-transparent stakes. As a result, public companies have legal means to ensure that they are informed about their ownership structures. In turn, listed companies are required to disclose their beneficial ownership structures to the general public.

Russian legislation does not recognise the notion of beneficial ownership and does not impose the obligation to disclose indirect stakes held by Russian shareholders. Companies that have publicly traded equity and/or debt are required to submit quarterly filings to the securities regulator. Ownership disclosure in these reports, however, is typically restricted to immediate shareholders, which may in fact represent nominee accounts or shell companies.

Domestic regulation remains fairly ineffective in ensuring ownership transparency of Russian companies. In practice, this means that disclosure of ownership is a voluntary move by shareholders. This is typically motivated by the need to attract capital on international markets by means of a public offer or a bond placement, or due to pressures from foreign shareholders, creditors or counterparties.

At the same time, political risks, crime, corruption and fears of persecution often provide contrary incentives to shareholders, especially the prominent industrialists. For instance, the transparent ownership structure of Yukos facilitated the task of the prosecutor's office in assembling evidence in their case against Mikhail Khodorkovsky and his associates. It may take considerable time before the tensions between the state and the business community ease, and necessary trust is developed, paving the way for greater transparency by companies.

Much room for improvement remains with respect to governance infrastructure and practices. Further progress depends to a great extent on the continued cooperation between the legislators, regulatory bodies, companies, market participants and international organisations.

The role of the Code of Corporate Governance

In 2002 the Federal Commission for Securities Markets (FCSM), Russia's securities market regulator, issued a Corporate Governance Code, developed with the technical assistance of the EBRD and the financial support of the government of Japan. This Code, incorporating the internationally accepted governance principles, was, although being voluntary by nature, in fact endorsed by the government and paved the way for further improvements, both regulatory and in practice.

The Code provides, among other issues, important guidelines on board composition (for example, there should be at least three independent directors and the audit committee should be composed of such directors) and transparency. The Code is not binding at present: joint-stock companies are only required to report compliance with the Code's principles (or lack of such) in their proxy statements and explain deviations from these principles.

While its bearing on Russian companies has been limited to date, the Code may start having a greater impact from 2006. Regulation Nr. 04-1245/pz-n issued on 15 December 2004 by the Federal Service for Financial Markets (FSFM), the FCSM's successor, was based on selected provisions of the Code (although no explicit references to the Code were provided). The regulation made these principles enforceable from 1 July 2005 with respect to those companies that have listed equity and/or debt. In addition, the regulation introduced a requirement to publish audited IFRS or US GAAP annual statements – a principle that was not specified in the Code, but followed its spirit.

When it became obvious in June 2005 that many listed companies would not be able to implement the specified criteria on time, the application of these governance guidelines was delayed until 1 January 2006. Unless further delays are authorised by the regulator, all listed Russian companies and those with listed debt issues (totalling around 60), will need to comply with these requirements.

This regulation may affect the issuers of listed securities in several ways. Few Russian boards have established effective committee structures (for example, only 29 out of the 54 largest public companies surveyed by Standard & Poor's have established an audit committee). As a result, improvements to board structures are expected as audit and compensation committees become mandatory when the regulation comes into force in January 2006.

Furthermore, independent directors, whose presence on Russian boards is currently limited, may see their influence increase as their numbers rise. This is in accordance with a new requirement to introduce at least three independent directors to each board. Independent audit committees are also set to be created. This is particularly important from a governance perspective given the concentrated ownership structure of Russian companies. Virtually all have controlling owners or blockholders: 46 companies in the sample of 54 were majority controlled, 6 others have at least one blockholding exceeding 25 per cent of votes.

The requirement to produce and disclose audited IFRS or US GAAP accounts is also an important positive step, particularly in view of Russian Accounting Standards (RAS) being of limited use for investors. For instance, RAS accounts are produced on a stand-alone basis, which obscures the financial impact of companies' affiliated businesses. According to the survey undertaken by Standard & Poor's, 43 out of 54 public Russian companies produced IFRS or US GAAP financial statements for 2004. The application of the code is likely to increase this number, which is positive from a governance perspective.

At the same time, the impending regulations do not specify a deadline for the filing of these financial statements. In contrast, a 90-day deadline for annual accounts typically applies in developed economies, while an extended 180-day period is applicable for foreign issuers listed on major international exchanges. The survey found only four Russian companies met the 90-day deadline, and only 26 companies published their IFRS or US GAAP accounts within 180 days past the reporting year.

Meeting the six-month period is a particularly important milestone for Russian companies, since annual shareholder meetings must be held before 1 July, and are typically convened in June. Availability of the more informative IFRS or US GAAP statements before the annual meeting is important for shareholders' understanding of the company's financial position. Apparently, there is much room for improvement in this respect as very few Russian companies follow this practice. The introduction of respective deadlines is currently being discussed by the regulatory bodies.

Unfortunately the recent regulations will not make many other provisions of the Code binding, for instance, the recommendation that boards conduct meetings at least every six weeks, and that specific strategically important issues be discussed in face-to-face meetings. Currently, few boards go beyond the legal requirement of conducting quarterly face-to-face meetings.

The Russian Code of Corporate Governance provides important guidelines on the composition of a company's board of directors and transparency. From 1 January 2006 some principles within the Code became enforceable by law.

Many questions remain regarding the implementation of Russia's Corporate Governance Code. For example, stock exchanges, which have been tasked with monitoring compliance, do not have the resources or expertise to assess issues such as directors' independence.

The present approach of the regulator in making selected provisions of the Code mandatory might stimulate companies focusing on these specific provisions. It may, however, neglect those sections and provisions of the Code that formulate the broader ethical principles of corporate governance.

Moreover, these selected requirements tend to focus on the governance structures rather then the effectiveness of the governance system. The focus on several narrow criteria may prevent the broader governance principles from gaining acceptance. This is particularly important in view of the virtual incapacity of Russian courts to base their decisions on substance and the spirit of laws and requirements rather than on their form and letter.

Also, although the recent regulatory initiative has the potential of raising governance standards at Russia's largest companies, many questions remain with respect to the implementation of the above guidelines. First, exchanges, which have been tasked with monitoring compliance, do not have the resources or expertise to go beyond the formal criteria in assessing such non-trivial issues as directors' independence. Russian exchanges are not used to performing regulatory or auditing functions since their role has traditionally been limited to the collection of filings, the accuracy of which remained the responsibility of the issuers. Moreover, their motivation to engage in rigorous checks and analyses is at the very least doubtful, since a de-listing on grounds of non-compliance would negatively affect an exchange's revenues.

Second, the effectiveness of the new regulations is to some extent undermined by several weaknesses in Russian legislation. For example, although the listed companies will be required to produce complete lists of affiliated entities – and update such lists on a regular basis – these are based on the narrow definition of a related (affiliated) party under the Russian law. (The law only encompasses direct affiliations.) This hampers the effectiveness of related-party transactions' reporting and monitoring. Similarly, little can be done to foster ownership transparency in the absence of deeper changes in the legislation.

Finally, the history of governance mechanisms in Russia is fairly short. Many important institutions are missing, such as an organised community of independent directors, understanding and enforceability of fiduciary duties, or a tradition of collegial decision-making by boards. This creates risks of superficial or window-dressing changes to companies' boards. These changes will be designed to ensure compliance with formal requirements while producing little effect on a board's decision-making.

For a number of reasons, the implementation of the Code's provisions in Russia appears to be a challenging task. Accordingly, the Code's influence on governance practices could be enhanced by greater attention and assistance from investment professionals and international organisations to implement various issues.

Conclusion

Over a relatively short period of time since the late 1990s, the collective effort of domestic and international communities of investors, governments and international organisations has led to several positive legislative changes in Russia. This effort has also contributed to a better understanding of the internationally accepted governance standards within the Russian business community. The development of the Corporate Governance Code was an important part of this process. It is therefore positive that the recent regulatory changes have the potential for increasing the impact of the Code by making several of its principles binding for issuers of listed securities.

Despite the improvements of recent years, several important weaknesses in the legislation and application of laws remain. The regulatory initiatives by the securities markets regulator (inspired by the Code), will help but alone will not be sufficient to address the most critical governance issues.

Furthermore, the application of the Code's provisions is restricted to a limited number of listed companies, and even in their respect, the effectiveness of the new regulations in raising the governance standards remains uncertain. Accordingly, further progress may depend on the cooperative efforts by domestic and international organisations and investment professionals in stimulating the much needed improvements in legislation, regulatory policies and general awareness of best governance practices.

Notes

[1] Standard & Poor's Governance Services, "Russian Transparency and Disclosure Survey 2005: Continuing progress in transparency, but mainly among weaker disclosers", published on 21 September 2005 on RatingsDirect, Standard & Poor's web-based credit analysis system: www.ratingsdirect.com.

[2] Standard & Poor's Governance Services, "Transparency and disclosure by Russian banks: Disclosure practices of Russian banks currently dismal", published on 26 October 2005 on RatingsDirect, Standard & Poor's web-based credit analysis system: www.ratingsdirect.com.

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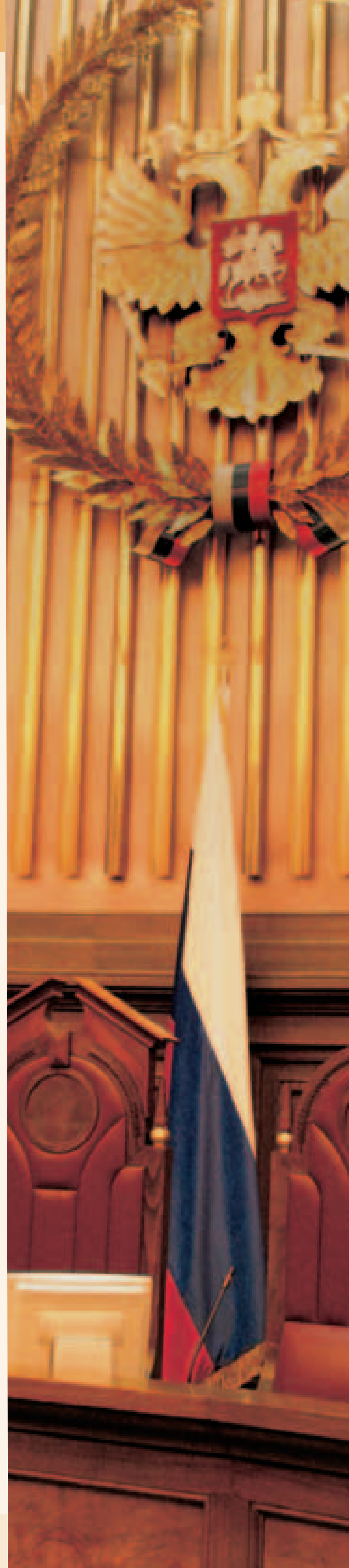
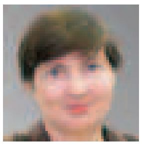


Corporate governance in Moldova: problems and solutions



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This article looks at the development of joint-stock companies and the establishment of corporate governance in Moldova. Further efforts are needed to improve current legislation, develop a draft code and raise awareness within the business community and general public of good corporate practices.

In the wake of mass privatisation in Moldova, one of the most pertinent problems remains the establishment of sound corporate governance in joint-stock companies. To safeguard the rights of minority shareholders, Moldovan laws need to be brought in line with international standards, the application of the law improved, an efficient securities market developed and corporate traditions established. Furthermore, the development of the law needs to be supported by a comprehensive and dynamic campaign promoting high standards of corporate governance and fostering public awareness of ethical business practices.

Privatisation of state property and the formation of corporate relations

Moldova's independence in 1991 and the subsequent adoption of the Constitution and the Property and Enterprises Acts made it possible for state property to be privatised. This process also included the conversion of state enterprises into joint-stock companies. The Property Act envisaged three kinds of ownership: private, collective and state. All of these could assume different organisational forms such as individual, family, cooperative or joint-stock companies.[1] Subsequently, this process led to the establishment of the first private enterprises, cooperatives, limited liability and joint-stock companies (see Chart 1).

Mass privatisation (known as "voucher privatisation") was based on a considerable number (around 100) statutory acts, including the Privatisation Act, the State Privatisation Programme Acts, the Joint Stock Companies Act and presidential decrees establishing the privatisation infrastructure.[2]

Upon adoption of the Privatisation Programme Act in 1995-96, it was acknowledged that mass privatisation in Moldova had become a real and irreversible process. The rate of privatisation of state property had risen significantly, especially in the second half of 1995, creating a firm foundation for the transformation of the national economy. The Act represented both the continuation of Moldova's State Privatisation Programme for 1993-94 and the beginning of a new stage of privatisation, which envisaged fundamentally new methods of privatisation that took into account the country's new economic, political and social conditions.[3] The Programme's main objectives included:

- creating the conditions required to stabilise, restructure and boost the national economy
- increasing the number of private property owners and the private sector's share of the economy
- establishing an effective corporate governance mechanism for the new economic entities
- developing a secondary market for shares and other securities as well as other infrastructural institutions of a market economy.

Forty-three privatisation funds and 11 trust companies were created to expedite and facilitate the mass privatisation process. As a result, thousands of Moldovans rapidly became shareholders with the vast majority entering into trust agreements with various privatisation investment funds (PIF) or trust companies (TC).

This system enabled individuals to transfer their registered National Property Vouchers (NPVs) to a management company acting as a trustee (a PIF or TC). Under the terms of a typical trust agreement, the trustee receiving the vouchers acquired the authority not only to invest them in shares of privatised enterprises but also to manage the assets and to exercise the associated property and personal non-property rights. Consequently, PIFs and TCs became collective owners of privatised enterprises.

Existing laws required the trustee to manage the assets solely in the interests of the individuals who had assigned their assets (NPVs or company shares). However, they also allowed the trustee to act in the interest of the person named in the trust agreement as the recipient of all income generated by the management of the assets.[4]

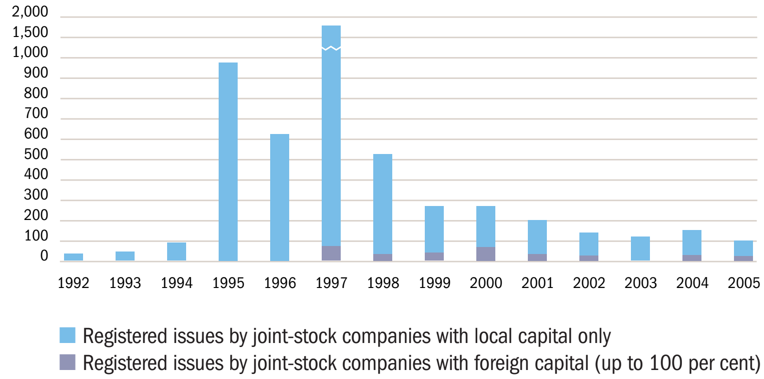
Based on official data, 3.1 million people or 89 per cent of all voucher holders participated in the mass privatisation programme either directly or through investment funds and trust companies. NPVs were used to privatise 2,235 enterprises (either fully or partially). Assets valued at approximately MDL 2.561 billion (approximately US$ 620 billion at 1 January 1994 prices) were distributed to the people.[5]

Corporate governance during the post-privatisation period

Privatisation of state property was one of the principal preconditions for the transition to a market economy. It was expected that, following the unavoidable economic downturn associated with this change, the economic situation of companies and the country as a whole would improve. However, in 1999 gross domestic product (GDP) was only 33.7 per cent of its 1990 level. In addition, only 4.5 per cent of joint-stock companies which submitted annual reports in 1999 to the National Securities Commission (NSC) reported a profit.[6]

Based on data for 2004, 49.1 per cent of the joint-stock companies which submitted annual reports to the NSC achieved profits totalling MDL 887 million (approximately US$ 70 million).[7] Though much improved, these results were still not satisfactory. It should be noted, however, that profits reported in company financial statements do not always reflect the true state of affairs. Often companies conceal their real profit in an effort to evade tax or more stringent corporate governance.

Chart 1 Emergence of joint-stock companies in Moldova 1992-2005



Note: The increase during 1995-97 is due to the waves of mass privatisation.

Source: National Securities Commission of Moldova 2005.

The early corporate relations environment

The new market conditions urgently required the establishment of a system governing the relationship between the management of newly privatised companies and their shareholders. Such a system was needed to ensure efficient operation of the company, as well as to safeguard the interests of shareholders and other stakeholders. There was no practice of corporate governance in Moldova at that time.

Initially, the reform process in Moldova focused on the transition from state management to corporate management. However, unlike developed countries, Moldova never had the benefit of sustained economic development or the continual democratisation of property relations. Therefore, the transition had to incorporate various preliminary measures aimed at creating organisational and legislative mechanisms safeguarding the interests of all participants, especially small shareholders.

It should also be noted that the general public lacked the most basic knowledge of property ownership rights and corporate relations. Raising public awareness of corporate relations and improving the structures protecting the rights of small shareholders remain serious problems to this day.

Generally, the joint-stock company is the most mature but also the most complex form (in terms of implementation) of organising large enterprises. This type of ownership has undergone continuous development and refinement over the centuries. Most importantly, it has developed in parallel with the democratisation of property relations. Therefore establishing corporate relations supporting this style of ownership is complicated in countries lacking a history of democratic rule.

Experience in Moldova has shown that one of the decisive elements of corporate governance is ensuring all members of the joint-stock company, both ordinary shareholders and management, are aware of the principles of effective interaction. In addition, all joint-stock

The development of company law needs to be supported by a comprehensive public awareness campaign covering the general concepts of corporate governance, the preparation and conduct of shareholders' meetings, the basic principles governing operations in a securities market and financial analysis of company operations.

company stakeholders must have the ability to exercise their rightsand duties. Consequently, the NSC focused, among other things, on developing a public awareness programme.

As part of this effort, the NSC organised corporate governance seminars on major topics including:

- the general concepts of corporate governance
- the preparation and conduct of shareholders' meetings
- the basic principles governing operations in a securities market
- financial analysis of joint stock company operations.

The management of privatised enterprises, investment funds and trust companies – as well as local employees of the Privatisation Department – were invited to these seminars. The NSC subsequently published several different publications on corporate governance. It also drew up and approved guidelines on the preparation and conduct of shareholders' meetings, as well as requirements on the disclosure of information by joint-stock companies and their associated entities.

The management of shareholder property

The government and its authorities had to address the imbalance between the interests and powers of participants in the ownership process. The management of the privatised enterprises were entrusted to hire managers with no or little ownership of the company's capital. Shares were separated out and large numbers of shareholders emerged, but little control mechanisms were put in place regulating outside managers. This lack of proper corporate governance was responsible for the loss of not only shareholder capital but also qualified personnel at many privatised enterprises.

Moldova has now adopted international accounting standards. In addition, the Joint Stock Companies Act requires every joint-stock company to set up an audit committee elected by the shareholders to safeguard their financial interests. Until recently, a company's annual financial reports were required to be audited and approved by independent auditors.

However, these regulations have not produced the desired effect. In practice, audit committees do not protect the interests of small shareholders. Neither do they detect irregularities in financial operations because they are largely dependent on company management. At the same time, independent auditors do not reveal the true state of affairs, simply rubber-stamp the financial information submitted to them by the management.

A new, more effective system of management must be developed on market principles and on providing incentives to improve a company's financial performance. Such management systems are still to be introduced and are needed to prevent the loss of shareholder capital.

Shareholders' rights in shareholders' meetings

The exercise of ordinary shareholders' rights depends largely on the procedures used for conducting shareholders' meetings. Existing laws do not encourage the observance of small shareholders' rights relating to their notification and participation in these meetings. For instance, until 2002 the Joint Stock Companies Act did not require all shareholders to be individually notified of a forthcoming meeting. This allowed companies to limit themselves to issuing notices in the publication specified in their statutes.

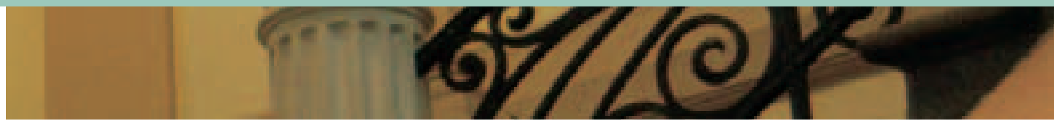
Newspapers, however, are not an accessible means of notification due to the high subscription costs. As a result, the overwhelming majority of small shareholders have long been deprived of any information on the operations of the companies in which they own shares. At the same time, joint-stock companies have been free from any control which could have been exercised by small shareholders. The right to reconvene shareholders' meetings irrespective of the number of votes represented at these meeting (in some cases less than 1 per cent of the total number of shares) has allowed groups of interested shareholders to exercise absolute control over a company.

That being said, the existence of a large number of small, entirely indifferent shareholders does makes it difficult or virtually impossible in practice to invite all shareholders to participate in shareholders' meetings.

Disclosure

Despite efforts by the official regulator and many laws setting out disclosure requirements for joint-stock companies, investors and the stock exchange, levels of transparency remain unsatisfactory. Usually, information is neither disclosed in full or in due time. What is more, over half of all joint-stock companies do not comply with the disclosure requirements in any way and provide no information whatsoever.[8]

The sale of shares is extremely rare in Moldova and there are often major price fluctuations between deals. In general, shares are bought to gain control over a company. The market is used mainly to concentrate ownership, making it a "companies market".



A shareholder's right to "vote with their feet"

In an active securities market, shareholders dissatisfied with a company's performance have the right and opportunity to sell their shares at a fair price and "vote with their feet". The availability of this option changes the management's attitude to shareholders. However, in Moldova the right to sell your shares and to sell them at a fair price exists only in theory.

At the present time, Moldova has all the components of a securities market in place. It has shareholders and issuers, as well as a market infrastructure: brokers/dealers, investment funds, a stock exchange, a depositary and clearing system, registrars, depositories and investment managers. Moldova also has an independent and very powerful government regulator – the NSC – as well as self-regulating organisations of securities market participants. However, the existence of market components is not a sufficient guarantee for its efficient operation.

Data show stock exchange capitalisation to be approximately MDL 5 billion (approximately US$ 400 million). Nevertheless, share deals are extremely rare and overwhelmingly based on agreements, with major price fluctuations between deals.[9] Shares are bought to gain control over a company. Thus, the market is used mainly to concentrate ownership, making it a "companies market".

Another factor that prevents fair share prices is the large number of "accidental" shareholders. Such shareholders are only interested in receiving dividends and in being able to dispose of their shares at short notice, thus flooding the secondary market.

Corporate culture in Moldova

Although international experts think quite highly of Moldova's corporate legislation, their esteem reflects the quality of provisions "on the books" rather than its application.[10] In addition, current laws must be amended so as to reflect the type and size of existing enterprises.

The vast majority of Moldovan joint-stock companies do not intend to use the tools of the securities market to raise funds. Their shares are only traded on the exchange if strictly necessary, and there is no regular dealing. As a result, these companies are in essence closed, although legally speaking they are regarded as open. (All joint-stock companies with more than 50 shareholders are classified as open.)

Large shareholders keep a firm reign over companies. Minority shareholders, of whom there are frequently over a thousand, have limited voting rights and virtually no opportunity to sell their shares.

It follows therefore that legislators must solve the dilemma of improving the quality of small shareholder rights and raise the level of observance of these rights. They must also, however, allow major shareholders (holding 90 per cent or more of a company's shares) to buy out small shareholders irrespective of their wishes.

Improving standards of corporate culture will promote a better application of corporate laws. This, in turn, will reduce shareholders' inertia and passivity. The observance of shareholders' rights is naturally influenced by external factors such as corruption and the poor training of law enforcement and judicial authorities. This stresses again the importance of:

- increasing the liability of auditors
- developing anti-corruption measures
- perfecting the training for executive and judicial authorities.

The current status of corporate governance and prospects for its enhancement

Developing an effective corporate governance system has become especially relevant in recent years. In Moldova, as in all transition countries, the task of enhancing – or rather establishing – corporate governance needs to receive as much attention as the privatisation process of the 1990s. Despite this awareness and increasing interest in issues of enhanced corporate governance, it remains significantly overlooked.

The NSC devotes considerable effort to improving the situation. For example, to support market transparency, the NSC has drawn up and approved the Standards of Specialised Accounting and Information Disclosure by Issuers and Securities Market Professionals. It regularly monitors compliance with the standards and imposes administrative penalties in the form of fines on those failing to comply.

A large number of problems, however, continue to exist. In particular:

- the Joint Stock Companies Act, the Securities Market Act, the Criminal Code and the Administrative Offences Code require improvement

- tax laws require enhancing
- a code of corporate governance needs to be developed
- events informing the general public about the securities market and corporate governance should be organised
- progressive corporate governance standards should be promoted within the business community.

Improving the Joint Stock Companies and Securities Market Acts, the Criminal Code and the Administrative Offences Code

The Securities Market Act, which came into force in 1999, has been amended four times. The Joint Stock Companies Act has been amended 12 times, reducing its 101 articles to 80 in the process. Currently, further amendments to these acts are being prepared, as are amendments to the Administrative Offences Act.

The proposed amendments to the Administrative Offences Act are intended to toughen penalties imposed on securities market participants for non-compliance with the regulations. This will ensure severe punishment of fraud and market manipulation. Moldova's Strategy for Securities Market Development for 2006-10 envisages drafting amendments to the Criminal Code and imposing more specific and harsher penalties for securities market offences. Their adoption will create a more favourable investment climate by protecting the interests of investors in the securities market and in corporate relations.

In view of the numerous amendments to these acts, it seems appropriate to draft new securities market and joint-stock companies acts based on European Union Directives, while taking into account local conditions. The tasks addressed by the new laws will include encouraging the application of progressive corporate governance principles by joint-stock companies.

Enhancing tax laws

The current tax code grants tax exemption on income from government securities, bank deposits and financial money market instruments issued by commercial banks. Share dividends, except for those paid by resident commercial entities to resident individuals not engaged in business are taxable, as is income on corporate bonds. It follows that the existing laws do not encourage the issue of corporate securities and thus, do not contribute to the enhancement of corporate governance.

Representatives of the NSC have spoken of the need to change this situation and create a favourable tax environment for corporate issuers and investors involved in securities transactions. In the last three years, the NSC has repeatedly discussed this problem with the Ministry of Finance and the Ministry of Economic Affairs, and has made official presentations to the government and the Ministry of Finance. Under the terms of a preliminary agreement, income on corporate bonds is to be tax exempt from 2007.

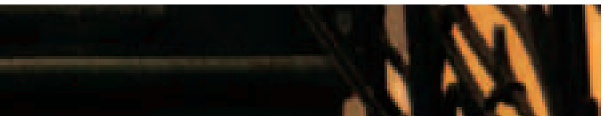
Preparation and promotion of a draft code of corporate governance

Throughout 2003-04 the NSC began drafting a code of corporate governance. It studied the OECD Principles of Corporate Governance, the draft of the Russian Corporate Governance Code, the legislation and practices of developed countries and other relevant research and publications.[11]

The mandatory provisions of the Joint Stock Companies Act, the Securities Market Act and other legislative acts were not included in the draft code as its role was to be advisory. By the end of 2004 the NSC had prepared the draft including only regulations which supplemented existing legislation. Nevertheless, if observed the code would promote improvements in corporate practices and increase transparency. Ultimately, the draft code would make joint-stock companies more attractive to investors.

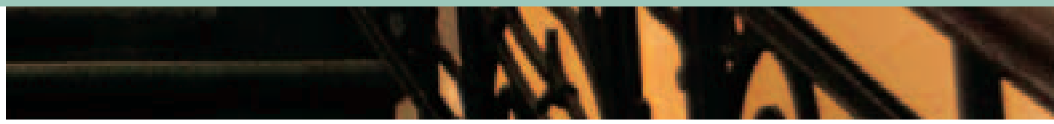
The draft code makes trust and mutual respect between participants in corporate relations fundamental principles. The duties and rights of each participant should be exercised, guided by the common interests of the joint-stock company as a whole and its shareholders. At the same time, the code bases the maintenance of investor and shareholder trust on:

- transparent management decision-making and implementation mechanisms
- the principle of equal treatment of all shareholders
- the development of partnership relations between the company and its employees in dealing with social problems and labour relations



The National Securities Commission is currently drafting a code of corporate governance. If observed, the code will promote improvements in corporate practices and increase transparency. It should also make joint-stock companies more attractive to investors.

The code of corporate governance must be understood and accepted by business and by majority shareholders. It is hoped that although the code is an advisory document, its provisions will be well received and observed by business.



- the individual accountability of members of the company's board and executive body to shareholders.[12]

In a joint assessment of Moldova's financial sector in 2004, the World Bank and the International Monetary Fund (IMF) carried out an evaluation of corporate governance in Moldova and correlated its current status with the OECD Principles of Corporate Governance. Their Report on the Observance of Standards and Codes (ROSC) of corporate governance was based on a standard questionnaire. The study produced a set of conclusions and comments on the status of corporate governance in Moldova as well as recommendations on its enhancement.[13]

In May 2005 a corporate governance enhancement project was launched based on the ROSC. It was supported by a Financial Sector Reform and Strengthening (FIRST) Initiative. The project called for an analysis current legislation and a new draft code of corporate governance, as well as amendments to the Joint Stock Companies Act and the Securities Market Act. A draft code prepared by the NSC was submitted to the project working group for review and incorporation.

It is expected a new draft code of corporate practice will be submitted for discussion by the end of 2006. The revised code will then be presented for approval by the government and the NSC.

A code of corporate governance, however, is not sufficient to produce real positive change in corporate relations. A code needs to be supported by a wide-ranging campaign to popularise good corporate governance. Its success will also be largely determined by the participation of the World Bank and the IMF. The code must be understood and accepted by business and by large shareholders as it is they who effectively own corporate assets and are responsible for their use. It is hoped that although the code of corporate governance will be an advisory document, its provisions will be well received and will be observed by business.

Informing the general public about corporate governance

With the general public lacking basic knowledge of the securities market and corporate law, an environment exists in which citizens' rights can be breached. In addition, this limited awareness contributes to an atmosphere of mistrust and fear in relation to shares and the market.

To change this situation, the government and the NSC should:

- draw up, publish and distribute free of charge information and guideline materials
- organise meetings, discussions and training sessions dealing with corporate governance for the general public
- organise cycles of daily television and radio broadcasts on corporate governance
- include specialised subjects into secondary school and higher education institution curriculum
- offer a professional development programme to civil servants, and in particular to court officials of all levels.

Putting these measures into practice will have a genuine impact on corporate relations, promote better corporate governance practices and, ultimately, aid the development of a democratic society. Implementation of these measures will be considerably advanced with the active participation of the World Bank and the IMF in the form of access to knowledge, experience and practice of international organisations.

Conclusion

It is hoped that the development of a new code and the implementation of an information campaign will have a positive impact on the corporate governance of Moldova's companies. At the same time, it shouldn't be overlooked that corporate governance represents only part of a broader economic context in which companies operate. It is also important to recognise that the structure of corporate governance does not solely depend on the legal, regulatory and institutional environment. To start the process of improving the management of shareholder property Moldova must, in parallel with improving the law, adopt a code of corporate governance and raise the level of awareness and respect for human rights and recognise the importance of justice in social relations.

Notes

[1] Republic of Moldova Property Act No. 459-XII of 22 January 1991.

[2] Vouchers were privatisation documents used in the privatisation process. They certified the share of state property attributed to the holder of the voucher.

[3] State Privatisation Programme for 1995-1996, Act No. 390-XIII of 15 March 1995.

[4] Presidential Decree No. 48 of 16 February 1994.

[5] Republic of Moldova Government Resolution No. 305 of 10 June 1994 on the results of National Property Voucher privatisation and the challenges of the post-privatisation period".

[6] National Securities Commission Report for 1999, www.cnvm.md.

[7] National Securities Commission documents supporting Resolution No. 32/3 of 14 July 2005, reporting the results of monitoring specialised annual financial reports submitted by joint-stock companies in 2004.

[8] National Securities Commission Resolutions No. 21/1 of 30 May 2002, No. 17/4 of 24 June 2003, No. 27/5 of 30 June 2004 and No. 32/3 of 14 July 2005.

[9] *Moldovan Stock Exchange Information Bulletin*, www.moldse.md and www.cnvm.md.

[10] V Allarousse (2004), "Making legal transition work in early transition countries", *Law in Transition online*, EBRD, pp. 1-11.

[11] EBRD (1999 and 2004), *Law in Transition online*.

[12] Draft Code of Corporate Governance, National Securities Commission, internal document.

[13] World Bank (2004), "Report on the observance of standards and codes (ROSC) – Moldova: Corporate governance country assessment", www.worldbank.org/ifa/rosc_cg_mdveng.pdf.

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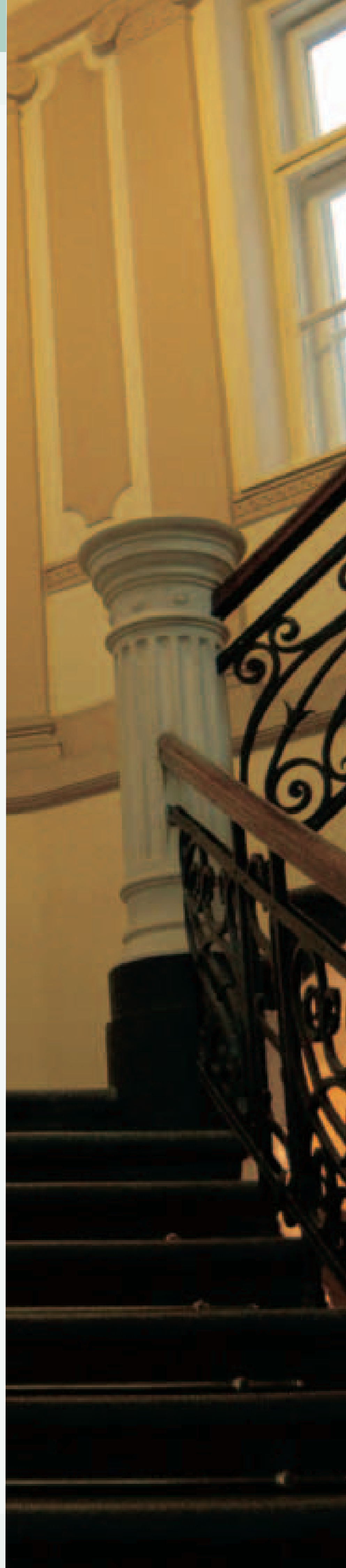

Investor protection in the Commonwealth of Independent States

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During 2005 the Inter-parliamentary Assembly of the Commonwealth of Independent States, with assistance from the EBRD, developed a Model Law on the Protection of Investor Rights in Securities Markets. This article discusses investor protection in the region and details the development of the model law.

On 14 April 2005 the plenary session of the Inter-parliamentary Assembly of the Commonwealth of Independent States (CIS IPA) approved the Model Law on the Protection of Investor Rights in Securities Markets.[1]

The CIS IPA is responsible for, among other things, promoting the harmonisation of legislation in the region. This is done by developing non-binding model laws based on good standards which are then recommended for use in the national legislation of member states.

The Commonwealth of Independent States (CIS) is made up of 12 member states: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. Turkmenistan and Uzbekistan, however, are not part of the CIS IPA. (The map on page 90 shows the ten member countries of the CIS IPA.)

The Model Law on the Protection of Investor Rights in Securities Markets is the second model law, after the Model Securities Markets Law (approved in November 2001), developed by the CIS IPA with the assistance of the EBRD.[2] A third EBRD-sponsored model law on bank insolvency has also been approved.

Currently, the EBRD is considering providing further assistance to the CIS IPA for the development of a model company law. This would represent the logical conclusion to the series of model legislative provisions, which are aimed at better regulating the business environment in the CIS. It would also introduce higher and more widely accepted standards within the commercial arena.[3]

To develop the Model Law on the Protection of Investor Rights in Securities Market, a working group was formed. This consisted of, among others, members of national parliaments who were involved with finance and economic committees, national experts representing national or central banks, ministers of finance or economy, academics and judges. This working group developed a draft law that reflected and recognised international standards in the area of investment law.

The Model Law on the Protection of Investor Rights in Securities Markets represents an important initiative that will assist the CIS countries in advancing their legal frameworks and improving investor confidence. It draws from:

- the OECD Principles of Corporate Governance 1999 (the new 2004 version of these principles, still being drafted at the time of project completion, was also taken into account)
- the OECD Basic Elements for Foreign Investment Legislation in the CIS
- the OECD General Principles of Company Law in Transition Economies
- relevant European Directives, notably the second Company Law Directive.

The first task of the working group was to establish a paper analysing current regimes and identifying their strengths and weaknesses, as compared with best standards. Given that the model law is a recommendation rather than a binding document, the idea was to draw on best standards and principles currently

Members of the Inter-parliamentary Assembly of the Commonwealth of Independent States (CIS IPA)

CIS IPA members CIS countries, not part of the CIS IPA

available in the area of investor protection, rather than tying it to current laws in a particular country.

A concept paper was then drafted which introduced best standards, while allowing the continuation of legal traditions and ensuring consistency with other current CIS model laws.

The final stage involved consultation with interested parties, soliciting commentaries and producing a first draft of the model law. The draft was subsequently refined and approved before being recommended to member states for consideration and implementation in national legislation. It is noteworthy that the provisions for another EBRD-sponsored model law on securities markets have been implemented in at least three CIS member states, namely Armenia, Russia and Uzbekistan.[4]

Reasons for harmonising the legal framework

Experience has shown that there is no single approach to investment protection in terms of the extent of protection sought or the mechanisms used to achieve it. Different legal systems use different tools to attain efficient protection standards. Nonetheless, there is a growing international consensus regarding the essential elements of an effective investment protection regime. Similarly, national regimes, particularly as far as large publicly listed companies are concerned, are starting to converge.

This consensus is reflected primarily in:

- the OECD Principles of Corporate Governance
- the EU Investment Services Directive and other EU directives[5]
- reports of various high level groups related to company laws and takeover rules
- the US Sarbanes-Oxley Act, sometimes referred to as the investor protection law[6]
- the EuroShareholders Corporate Governance Guidelines
- the codes of conduct and listing requirements of the largest stock exchanges throughout the world.[7]

All these guidelines and principles were taken into consideration when forming the Model Law on the Protection of Investor Rights in Securities Markets. They effectively established the basis for the law.

The importance of investor protection

Recent studies in the field of corporate governance indicate that the ability of companies to attract capital largely depends on the rights the legal system provides to investors, as well as the enforcement of these rights.[8] In particular, the quality of mechanisms for investor protection affects not only the development of capital markets but also the variety of instruments available, the ownership structures, the dividend policy and, more generally, investor appetite.

When investing funds in a company, investors expect to receive certain rights in return for their capital. These rights include:

- the right to vote on the board of directors
- the right to vote on the charter and on charter capital changes
- the right to vote on the approval of annual reports and financial statements
- access to certain information about the company and its activities
- partaking profits of the company.

Investor rights need to be protected, hence the need for rules to be honoured by all participants of the corporate environment, including other shareholders, creditors, managers and directors, the state and its employees. Through these rules, investors ensure their equitable treatment and their right to information disclosure and transparency. This enables them to make investment decisions. Such rules also provide for certain responsibilities of the board and govern the role of other stakeholders. These issues are particularly important in the context of transition economies.

Other CIS model laws related to investor protection include the Model Civil Code, the Model Joint Stock Companies Law, the Model Limited Liability Companies Law and the Model Securities Markets Law.

The 1996 Model Joint Stock Companies Law, however, is very limited in scope and was only meant to cover a company's activities and not investor rights. Moreover, this Law was developed over a decade ago and does not take into account current international standards.

The Model Securities Markets Law mainly deals with the issue and circulation of securities and licensing of capital market participants. It neglects questions of professional duties, competencies of state bodies and investor protection.

Generally, civil codes in all the CIS countries recognise the protection of basic investor rights and refer to procedures and mechanisms to do so. The more detailed regulation is left to other laws and codes and secondary regulation. As such, some countries – namely Azerbaijan, Russia and Uzbekistan – have adopted special laws dealing with the protection of investor rights in securities markets.

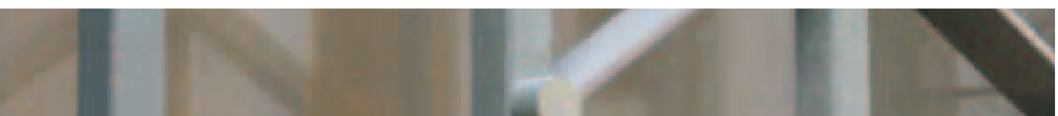
Nevertheless the more common approach is to deal with various aspects of investor rights in different legal acts. Such legal acts usually relate to company law and securities legislation.

Improving legislation in the CIS

The first generation of legal acts dealing with aspects of investor protection was adopted in the CIS in the early 1990s. Given the common legal heritage and the absence of prior legislative regulation of different types of commercial entities, the concept of investors and the need for protecting their interests became obvious only after the collapse of the Soviet Union and the transition to a market economy. Technical assistance provided by Western institutions for the development of commercial legislation resulted in the emergence of legal acts regulating different aspects of these rights. However, the mechanisms developed for investor protection in various CIS countries differ substantially.

The late 1990s and early 2000s witnessed a second wave of revisions and refinement of the regulation in this field. Depending on the problems faced, some countries developed their own legislation ensuring investor protection.

Frequent changes to legislation, however, are not viewed favourably by the private sector. As a result, new legislation is often not widely discussed with those affected by it. Rather, it tends to reflect only the views of the regulators or the state. In other instances, large lobbying groups influence legal changes and sometimes even hinder reforms. Similar concerns can be raised over the fact that in most of the CIS countries, official or even informal translations of key legal acts are not available.

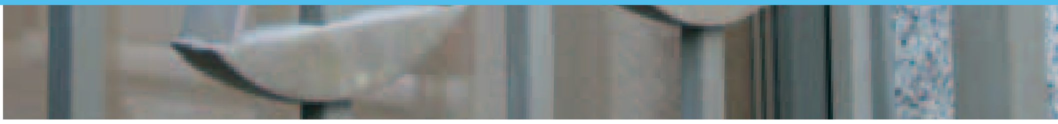


The Model Law on the Protection of Investor Rights in Securities Markets will assist the countries in the Commonwealth of Independent States advance their legal frameworks and improve investor confidence.

Of critical importance too is the way investor rights are enforced in practice. Research in the CIS clearly indicates that investor complaints have only been brought before a court or regulatory body in a few countries. In some countries, judicial practice in this field is still underdeveloped. Furthermore, only a limited number of cases related to the protection of investor rights have been filed in courts of the CIS countries.

Such inadequate and insufficient practical application has prevented the supreme courts of the CIS to analyse and summarise legal cases and, ultimately, draft instructions and recommendations for lower courts. Some of the reasons for the low level of enforcement may include, but are not limited to, corruption, unsatisfactory professional competence of judges, legal illiteracy among investors and the absence of a proper infrastructure.

The term “investor protection” covers the rights of different types of investors and the measures they can take to enforce and protect these rights.



Defining investor protection

Shortly after the CIS countries opened their markets to foreign investment, the term “investor protection” was used to signify the protection of foreign investors from state interference. This interference included nationalisation, profit repatriation and other restrictions in legislation.

This understanding of investor protection formed the basis of the 1997 Model Law on the Protection of Investors’ Rights. That model aimed to:

- protect foreign investors from arbitrary or unequal treatment and changes in legislation
- guarantee their right to compensation in case of expropriation
- provide guarantees regarding the disposition on revenues.

The protection of investors is also often written into legal acts that do not specifically deal with the issue, for example company law, tax, secured lending, bankruptcy law or securities regulations. Most countries do not have a single specific legal act that comprehensively deals with the protection of investors. Rather, different aspects of investor protection are regulated by various branches of the law. Because of this, certain issues are not sufficiently regulated, whilst some aspects are not regulated at all. To address these shortcomings, it may be necessary to develop a separate legal act that addresses these problems.

Another issue worth examining is the definition of the term “investors” and the rights subject to protection. In order to avoid any doubt, the Model Law on the Protection of Investor Rights in Securities Markets is limited to the discussion of the rights of investors in securities markets and leaves aside the regulation of rights of creditors and bank depositors.

The relationship between the terms “investor protection” and “investment protection” should also be clarified, as should the distinction between the regulation of investor rights and investment activities. These two terms are linked but are essentially different. The scope of investment protection includes issues such as the legal regime of investment, currency regulations, tax advantages and other privileges. The term “investor protection”, however, covers the rights of different types of investors and the measures they can undertake to enforce and protect these rights. This is the focus of the Model Law on the Protection of Investor Rights in Securities Markets.

Common issues affecting investor protection in the CIS

Problems related to investor protection in the CIS include:

- Ownership rights of investors are violated through the manipulation of the shareholder register.
- Minority shareholders are squeezed out of a company through the dilution of stocks or withholding dividends.
- Minority shareholder rights are violated in the course of consolidation of shares and the reorganisation of companies.
- Profits of the company are channelled to third parties through transfer pricing and self-interested transactions.
- Duties of controlling shareholders are not defined, opening the way to misuse.
- Duties of management bodies are barely defined, making it difficult to establish if managers have violated their duties.

Table 1 Regulation of issues affecting investor protection legislation in CIS countries

	Armenia	Azerbaijan	Belarus	Kazakhstan	Kyrgyz Rep.	Moldova	Russia	Tajikistan	Turkmenistan	Ukraine	Uzbekistan
Special law on investor protection	No	Yes	No	No	No	No	Yes	No	No	No	Yes
One share – one vote	Yes*	Yes	Yes	Yes*	Yes	Yes*	Yes*	Yes	Yes	Yes	Yes
Pre-emptive rights	Yes*	No	Yes	Yes	Yes*	Yes*	Yes	No	No	Yes	Yes*
Voting by proxy	Yes	Yes	Yes	Yes*	Yes*	Yes*	Yes*	na	Yes	Yes	Yes
Approval of dividends	Board/GM	GM	GM	Board/GM	GM	Board/GM	GM	Board/GM	GM	GM	Board/GM
Central depositary	Yes	No	na	Yes	na	No	No	na	na	na	na
Liability of controlling shareholder	Yes	No	na	No	No	No	Yes	No	No	No	Yes
Takeovers rules	No	No	No	Yes	Yes	Yes	Yes	No	No	No	No
Minority squeeze-out rules	No	No	No	No	No	No	No	No	No	No	No
Related-party transactions rules	Yes	No	No	Yes	Yes	Yes	Yes	No	Yes	No	Yes
Derivative suits	Yes	No	na	Yes	No	Yes	Yes	No	No	No	Yes
Cumulative voting	Yes	No	na	Yes	No	Yes	Yes	na	na	No	Yes
Redeemable shares	No	No	na	No	No	Yes	No	No	No	No	No
Disclosure of ownership thresholds	Yes	No	na	Yes	na	na	Yes	na	na	Yes	na
Disclosure of material events	Yes	na	na	No	na	na	Yes	na	na	No	na
Liability for false information	Yes	na	na	Yes	Yes	na	Yes	na	na	Yes	na
Enforcement by SROs	Yes	Yes	na	Yes	na	na	Yes	na	na	No	Yes
Compensation schemes	No	Private	No	No	No	No	Public	No	No	No	No

No Yes na = no data available

Notes: The table is based on information collected during project implementation. Data on Georgia were not available. * indicates some limitations apply. Dividends can be approved by either the board or the general shareholders' meeting (GM). SRO is a self-regulatory organisation. SROs can be a national securities exchange, registered securities association, or registered clearing agency authorised by law to regulate the conduct and activities of its members, subject to oversight by a specified government regulatory agency.

Source: EBRD 2005.

- Mechanisms to hold managers and auditors liable are insufficient.
- Jurisdiction and competencies of capital market supervisory bodies are too restricted.
- Investors are not provided with sufficient information from companies and professional participants of securities markets.
- Internal and external financial controlling and auditing should be more effective.

Some key aspects of the current regime of investors' rights regulation in the CIS countries are summarised in Table 1.

Adopting an effective approach

Investor protection is a complex area of regulation, both in domestic jurisdictions and internationally. Bearing in mind the specifics of the legal systems in the CIS, as well as of the best international (and regional) legislative developments, the team drafting the model law made a number of methodological choices.

First, the decision was taken to draft model legislative provisions rather than a single comprehensive model law. One reason for this was that investor protection is covered by several areas of the law, most notably company law and securities law.

In most legal systems, including the countries of the CIS, company law and securities law are embodied in separate legislative acts. Thus, in the case of investment protection, the CIS IPA sought to achieve better modernisation and harmonisation by providing a flexible package of legislative provisions. These provisions can be used selectively by legislators in individual jurisdictions to amend or supplement different legal acts.

The drafting team suggested the document take the form of a "black letter rule", with a commentary for each model legislative provision. This corresponds to some of the best

As investor protection is covered by several areas of law, most notably company law and securities law, the CIS IPA developed a flexible package of legislative provisions which could be used selectively by legislators to amend or supplement different legal acts.

international practices in the area of voluntary harmonisation of laws. The same approach was adopted, for example, by the International Institute for the Unification of Private Law (UNIDROIT) in drafting the Principles of International Commercial Contracts or by the OECD in drafting the Principles of Corporate Governance.

As the model legislative provisions can be used selectively, the following issues were addressed in the commentary:

- The rules contained in the model legislative provision were explained.
- The choices made in proposing a particular rule were justified. When developing the legal provisions, the drafting team endeavoured to take stock of best practices, as well as the experience of legal and economic reform in transition countries over the last decade. Given that there are significant differences of opinion on how to approach certain issues, the drafting team provided explanations of why certain solutions were (or were not) adopted.
- The policy issues behind the particular rule were explained. Often in this area of regulation, there is a fine balance between the interests of shareholders, creditors, directors, employees and society at large. This balance is made on the basis of various factors – strategic, economic and cultural – in addition to those pertaining purely to law. Thus, while proposing a certain solution, the drafting team was careful to highlight the policy concerns behind it.
- Different options for adopting a particular rule were considered.

Together with the international community the drafting team undertook a consultation process within the CIS countries.[9]

In addition to the Model Law on the Protection of Investor Rights in Securities Markets, the following documents were produced:

- an analysis of investor protection laws in CIS countries (in English and Russian)
- a concept paper on model legislative provisions (in English and Russian).

Conclusion

It is yet to be seen what impact the Model Law on the Protection of Investor Rights in Securities Markets, and indeed other model laws developed with the EBRD's technical assistance, will have on national legislation within the CIS IPA member states. The CIS IPA Standing Economic and Finance Commission has decided to request information from national parliaments as to whether and to what extent provisions of the 35 model laws developed and subsequently approved by the CIS IPA have been used in national legislation. It will be some time before the model laws and provisions find their way into national laws.

The EBRD's assistance (both at the regional and country level) has proven a powerful tool for reform. The success of this project has been the drafting team's ability to maintain legislative traditions, whilst establishing common legal roots in the region. While ensuring the best available standards are disseminated, individual countries are able to adjust their legislature to the individual situation in that country subject to its legal policies.

Notes

[1] For more information, see the CIS IPA web site: www.iacis.ru. The text of the model law is available in English and Russian on the EBRD web site: www.ebrd.com/country/sector/law/corpgov/projects.

[2] The project was funded by the Dutch Technical Cooperation Fund. The costs of logistics and transfers in St Petersburg as well as the costs for deputies of national parliaments participating in the meetings in St Petersburg, were covered by the CIS IPA. Some of the costs associated with a German expert were met by the German Gesellschaft für Technische Zusammenarbeit mbH (GTZ).

[3] The EBRD supported the development of the following CIS model laws: CIS Model Securities Markets Law (approved on 24 November 2001); CIS Model Law on the Protection of Investor Rights in Securities Markets (approved 14 April 2005); CIS Model Bank Insolvency Law (approved 18 November 2005).

[4] The text of the model law is available in English and Russian on the EBRD web site: www.ebrd.com/country/sector/law/corpgov/projects.

[5] For further information see: europa.eu.int/comm/internal_market/index_en.htm.

[6] The Sarbanes-Oxley Act is a US federal law enacted in 2002. Officially titled the Public Company Accounting Reform and Investor Protection Act of 2002 (and commonly called SOX or SarbOx), the act covers issues such as establishing a public company accounting oversight board, auditor independence, corporate responsibility and enhanced financial disclosure. It was designed to review the dated legislative audit requirements and is considered the most significant change to US securities laws since the New Deal in the 1930s. The act came in the wake of a series of corporate financial scandals including those affecting Enron, Tyco International and WorldCom (now MCI). The law is named after sponsors Senator Paul Sarbanes and Representative Michael G Oxley.

[7] A list and texts of corporate governance codes in force is available on the European Corporate Governance Institute web site: www.ecgi.org/codes/all_codes.php.

[8] See R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny (1997), "Legal Determinants of External Finance", *Journal of Finance*, Vol. 52 (3), pp. 1131-1150 and (1998), "Law and Finance", *Journal of Political Economy*, Vol. 106 (6), p. 1113.

[9] In particular, the Model Law on the Protection of Investor Rights in Securities Markets benefited from a number of commentaries received from the parliaments of Azerbaijan, Armenia, Belarus, Kazakhstan, Moldova, Russia and Ukraine; the high courts of Belarus and Russia; the Kazakhstan Financial Market Regulator; the national banks of Belarus, Georgia, Kazakhstan, Russia and Tajikistan; the Ministry of Finance of Russia; the Ministry of Economy of Belarus; the World Bank and the International Finance Corporation; the Association of Banks of Moldova; the Law Faculty of St Petersburg University; the US Securities and Exchange Commission and the Russian Investor Protection Association.

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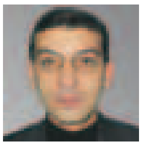
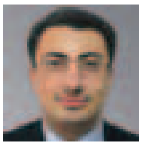
Corporate governance in Armenia:
developing a company rating system

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To establish corporate governance principles throughout its business and banking environment, Armenia has introduced a company rating system which has had positive effects on the stability of the market and of monetary policy.

Strengthening corporate governance is an issue of pivotal importance in Armenia. The quality of corporate documentation is generally poor, with companies adopting dual accounting systems to avoid income taxes. In addition, minority shareholders receive limited information – a deficiency that sustains inequality and mismanagement.

In an effort to improve corporate governance practices, the Central Bank of Armenia (CBA) has taken over the functions of the Armenian Securities Commission (from January 2006). Along with this consolidation, a company rating system has been developed to improve the quality of financial disclosure and generally secure the implementation of corporate governance principles.

After the collapse of the Soviet Union, Armenia along with many other new states moved towards a market economy. Naturally, the institution of new, market-oriented economic relations required the formation of a completely new financial system.

A range of targeted policies have facilitated the rapid and sound transition of parts of the financial sector. However, unlike the banking system which has advanced concurrently with the economy, progress in the securities market continues to lag far behind.

The impact of an under-developed securities market

The government bonds market is the only sector within Armenia's securities market which has improved considerably since the beginning of transition. The corporate securities market remains substantially underdeveloped in comparison. Traded shares of several open joint-stock companies with limited market turnover have tended to dominate this market.

Due to the absence of a corporate bonds market, businesses in Armenia depend exclusively on loans and borrowings. These loans and borrowings usually have high interest rates and short maturities that make investment projects costly. They also tend to lessen the rate of return on investments. Furthermore, lenders themselves often find it difficult to access information concerning possible credit risks, analytical reports and expert publications.

In this context, fostering interaction between the financial and corporate sectors of the Armenian economy is critical to achieving the necessary level of financial intermediation. It is essential that an authority which can assign unbiased and standardised performance ratings to local companies is established. This will, at the very least, allow a comparative assessment of Armenian businesses on the basis of risk measurements.

Rating agencies in Armenia

International experience has shown that suitable independent companies can efficiently evaluate a company's risk exposure. In some countries such a rating is also provided by central banks. In these cases, the rating is mainly used to guide operations (such as refinancing) of the respective central bank.

In the case of Armenia, the absence of a private rating agency can be explained by the lack of demand for ratings, and the time and cost required to establish such an agency. Rating agencies usually emerge when there is demand from the already developed securities market, the prime consumer of the rating service.

The Central Bank of Armenia (CBA) believes that introducing a company rating system will greatly contribute to the implementation of corporate governance principles in businesses.

The CBA's decision to initiate a company rating system was based on the need to:

- improve corporate governance
- develop monetary policy tools.

The rating system as a tool for improving corporate governance

The CBA believes that introducing a company rating system will greatly contribute to the implementation of corporate governance principles in practice. Establishing the best international corporate governance principles is also of utmost importance for further developing the Armenian economy and increasing the level of capitalisation in businesses.

The authorities have undertaken a number of measures to introduce corporate governance principles in the corporate and banking sectors. In particular, the CBA has developed an effective structure to introduce these principles into commercial banks. As part of this structure, it has initiated a range of relevant legal provisions and operational measures.

The coordination of consultative hearings and expert discussions with representatives from commercial banks and international professionals can be seen as further evidence of the CBA's commitment.

Enhancing monetary policy tools

The need for enhancing the CBA's monetary policy tools represented another important reason for initiating a company rating system. As international practice has shown, effective monetary policy implementation often requires central banks to consider private securities as collaterals, thereby transforming those securities into indirect instruments of monetary policy. In this regard, it is necessary for central banks to acquire unbiased facts relating to the financial and economic performance of the issuers of such debt securities.

Furthermore, the change from an exchange-rate to an interest-rate dominated monetary policy has necessitated an enhancement of the CBA's operating instruments. The interest-rate approach is far more appropriate in the light of the inflation targeting that Armenia will adopt in 2006.

Thus, the CBA has introduced a company rating system to:

- maintain the stability of the financial markets
- develop sound economic relations between the corporate and financial sectors
- increase the effectiveness of monetary policy.

Company rating procedures

In order to facilitate the rating process, the CBA has developed a specific methodology that comprises a proper investigation of credit history, as well as quantitative and qualitative analysis of a company's activities and performance. The three components of the overall rating are graded from 1 to 5, with 1 the lowest rating and 5 the highest rating. The final rating score is calculated by weighting the three separate grades (see Chart 1).

Investigating a company's credit history

The first stage of the rating process involves the thorough scrutiny of a company's credit history. Its primary objective is to evaluate the company's record of honouring previous and current loan or other credit obligations. A range of data such as the repayment schedule of received loans and their interest payments, the number of overdue days, the principal amount of the loan and its interest (if available) are studied. This data are obtained from the CBA's credit registry and, in some cases, extracted from information given by commercial banks and the businesses to be rated.

Quantitative analysis

Quantitative analysis of business performance is done on the basis of a company's financial statements. In order to guarantee trustworthiness and reliability of data, financial statements approved by independent audit companies are preferred. While performing the quantitative analysis, special attention is paid to:

- the quality of assets
- the structure of the company's capital
- economic activity
- the company's overall performance, particularly return on assets and equity.

The quantitative analysis is then carried out by using a system of financial ratios.

Qualitative analysis

The qualitative rating for business activities is determined through a questionnaire developed by the CBA. The questionnaire is sent to the management of selected companies

and consists of two main parts.
The first section evaluates the external environment of the business, while the other assesses its internal structure. During investigating and analysing the latter, special attention is given to business strategy, application of corporate governance principles, as well as the quality of management and human resource policies.

Particular consideration is paid to corporate governance measures including the thorough examination of:

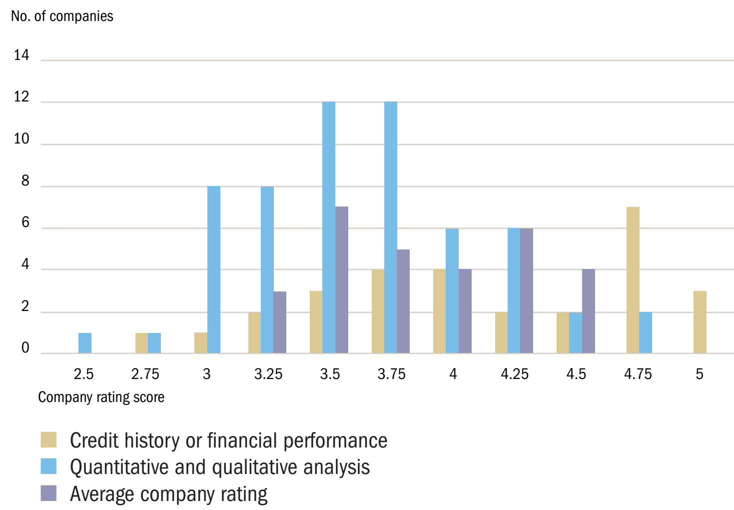
- the separation of management and ownership
- proper rules and regulations
- information transparency
- accountability to shareholders
- proper protection of minority shareholders' rights.

The analysis of the external environment highlights the relations of the company with its consumers, suppliers, competitors and tax and regulatory authorities, as well as its competitive position and the diversification of the distribution network.

Rating results

Preliminary tests of the methodology were introduced by the CBA. About 30 well-known and large businesses were provisionally rated. The final rating system was, however, only introduced after a probation period involving the testing and adjusting of the methodology.

Chart 1 Company rating scores in Armenia



Note: The ratings range from 1 to 5, with 1 the lowest and 5 the highest rating given to a company.
Source: Central Bank of Armenia 2005.

The rating system depends on two main conditions:

- voluntary participation (ratings are only done upon the request of a company)
- availability of reliable information about the company's activities.

In order to be rated, a business must fulfil the eligibility criteria of having an annual total income of more than US$ 100,000 and not be involved in the trade sector (wholesale or retail).

The letters of the Armenian alphabet are used as grades (for simplicity Latin equivalents are used throughout this article). The best grade is "A", the worst is "H". Until now about 30 companies have undergone rating procedures and none of them have been assigned the highest grade. Four companies received "B" and 11 received "C" ratings.
The lack of "A" grades was mostly due to the absence of corporate governance principles in the Armenian business environment. Only two among the rated companies had introduced corporate governance principles. This was due to their management being trained abroad and their ownership structure comprising of foreign capital.

In line with the rating principles, the CBA published the names of businesses with high ratings ("A", "B" and "C").
If the grade was lower (from "D" to "H") the name of the company was published only after the company in question consented.

The CBA has developed a specific rating methodology that comprises a proper investigation of a company's credit history, as well as quantitative and qualitative analysis of the company's activities and performance.

Improving the legal environment

Together with the rating system, the CBA has encouraged changes in the legal framework of the banking system to facilitate the rating process. The grades given by the CBA will be used to:

- enable a company to use their securities as collateral for the sale and purchase of repo operations;[1] at present repo agreements can only be ratified against short-term government bonds, however, the CBA is now ready to accept bonds of highly rated companies as a guarantee in repo agreements
- apply favourable risk weights to bank loans and assets while measuring a bank's capital adequacy (this implies both loans to the rated businesses and purchases of their corporate bonds by banks); this will encourage commercial banks to extend credit to highly rated companies as well as to acquire their bonds.

Market access

The CBA, in agreement with the Armenian Stock Exchange, has announced that highly rated companies can operate under significantly relaxed terms relating to the issuance of shares and bonds and their turnover requirements. These companies therefore have the opportunity to attract the necessary financial resources by means of giving out securities.

Introducing corporate governance principles

Giving new companies access to the securities market will boost the liquidity of the market and offer favourable conditions for investment. Such changes could also generate the necessary incentive for generally introducing corporate governance in companies. In particular, these developments could have positive effects on the rights of company shareholders in guaranteeing equal competency of all shareholders as well as encouraging proper management and transparency in all activities of the company.

The latter is especially important for Armenia as many businesses act in the shadow economy to avoid tax obligations. Such companies will have to make the choice of either remaining in the margins and suffering from a lack of financial resources or of acting transparently and thereby meeting their financial requirements through access to the securities market.

The Armenian authorities and the CBA will continue to support the introduction of corporate governance principles in the business and banking sectors. This will greatly improve the overall business environment of the country and contribute to the successful international integration of its corporate entities.

Notes

1 Repurchase agreements (repos) are collateralised lending transactions. One party agrees to sell securities to the other against a transfer of funds. At the same time the parties agree to repurchase the same or equivalent securities at a specific price in the future.

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