

# Assessing corporate governance and securities market legislation in Early Transition Countries

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**The European Bank for Reconstruction and Development (the EBRD) has recently performed two assessments on corporate governance and securities markets legislations in its 27 countries of operation<sup>2</sup>. The initiatives are devoted to evaluate the extensiveness (i.e. the law ‘on the books’) of corporate legislation and securities markets legislation and their compliance with the Principles of Corporate Governance issued by the Organisation for Economic Cooperation and Development (OECD) and the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions (IOSCO).**

Following the assessments, countries have been divided in five categories according to the score reached. ‘Very high compliance’ means that the international principles are fully transposed in the national legislation. Countries rating ‘high compliance’ have existing law relatively sound in the majority of areas highlighted by the principles while those scoring ‘medium compliance’ have areas of concern where improvements are needed. ‘Low compliance’ indicates a situation where the general quality of the legislation should be improved and ‘very low compliance’ is a symptom of a legal system which needs urgent reform<sup>3</sup>.

The present article aims to describe the results of these two assessments focusing on Early Transition Countries (ETC) and evidencing the areas where reform should be addressed. The ETC initiative was launched in April 2002 to stimulate market activity and foster transition in Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan and

Uzbekistan, the poorer countries in the region. To move forward, these seven countries need to increase their levels of financial intermediation and strengthen their regulatory environments. Through its Legal Reform Programme, the EBRD is fully committed to supporting the legal and institutional aspects of the ETC initiative, and creating a better living environment for the people in the region<sup>4</sup>.

Comparing the results, Azerbaijan, Tajikistan and Uzbekistan obtained similar scores in both assessments. Georgia, and the Kyrgyz Republic rated medium compliance in one assessment and low compliance in the other.

Armenia’s results were the best among the ETC, having a legislation resulting ‘high compliant’ with OECD principles and ‘medium compliant’ with the IOSCO’s. Moldova, however, shows legislation on corporate governance generally in line with OECD principles but with serious shortcoming when compared with IOSCO principles.

**Figure 1: Corporate governance assessment**

Corporate governance assessment				
Very high compliance (No countries)	High compliance (9 countries)	Medium compliance (10 countries)	Low compliance (4 countries)	Very low compliance (4 countries)
	Armenia	Albania	Bosnia & Herzegovina	Azerbaijan
	Hungary	Bulgaria	Georgia	Belarus
	Kazakhstan	Croatia	Romania	Tajikistan
	Latvia	Czech Republic	Turkmenistan	Ukraine
	Lithuania	Estonia		
	FYR Macedonia	Kyrgyz Republic		
	Moldova	Serbia & Montenegro		
	Poland	Slovak Republic		
	Russia	Slovenia		
		Uzbekistan		

**Figure 2: Securities markets legislation assessment**

Corporate governance assessment				
Very high compliance (No countries)	High compliance (5 countries)	Medium compliance (15 countries)	Low compliance (4 countries)	Very low compliance (3 countries)
	Croatia	Armenia	Albania	Azerbaijan
	Estonia	Bosnia & Herzegovina	Belarus	Tajikistan
	FYR Macedonia	Bulgaria	Moldova	Turkmenistan
	Lithuania	Czech Republic	Kyrgyz Republic	
	Slovenia	Georgia		
		Hungary		
		Kazakhstan		
		Latvia		
		Poland		
		Romania		
		Russia		
		Serbia & Montenegro		
		Slovak Republic		
		Ukraine		
		Uzbekistan		

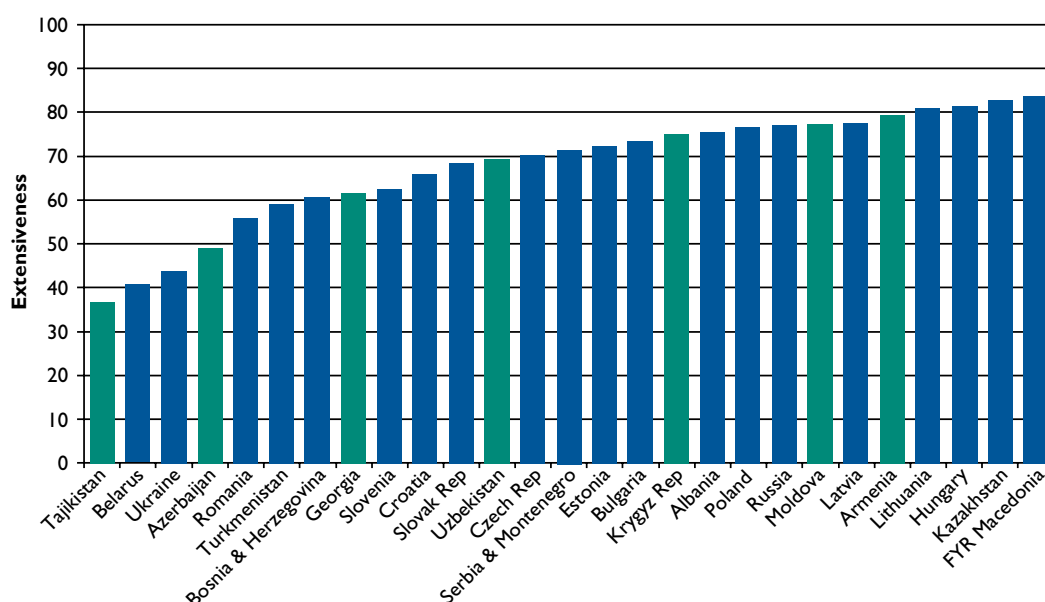
## Azerbaijan

In Azerbaijan the law regulating joint stock companies was enacted in 1995 and amended both in 1996 and 1999. While the law is regulating several fundamental issues relating to the operations of joint stock companies, it is still inadequate in many key issues concerning corporate governance. In particular, the law is silent on the requirement to maintain a share register and it is not clear whether the registration constitutes proof of ownership. While the law provides for a duty to disclosure

significant shareholdings, there are no sanctions in case of breach. The law also showed serious shortcomings with reference to the basic duties of directors and the standards for exercising their functions. Transparency and disclosure requirements are problematic thereby making the law inadequate in protecting the company against self-dealing and conflict of interest issues.

The Azeri law on securities was issued in 1998 and no major amendments since then have been registered. A stock exchange exists, but the

**Figure 3: Corporate governance extensiveness**



regulator has no monitoring or surveillance powers. Investment protection measures and prudential requirements are very limited and legislation on prospectus, disclosure and listing requirements should be improved. Requirements for licensing of collective investment schemes and rules on disclosure duties and segregation of assets are not clear. Shares are not dematerialised, and securities clearance is not centralised. Finally there is no legislation in place to address money laundering. As a result, room for improvement remains in all areas.

## Tajikistan

The situation is similar in Tajikistan. The law on joint stock companies was adopted in 1991 and has been amended several times since then. A new law is presently being discussed at Parliament and is expected to be approved shortly. The new law aims to significantly increase shareholder rights, improve corporate governance and company procedures, as well as increase minimum registered capital and rule out closed-type joint-stock companies. While the existing law provides a basic framework governing the formation, operations and liquidation of joint stock companies, it is silent on many important issues concerning minority shareholders and general investors. One of the major shortcomings is that the law does not require equality of voting rights among shareholders and lacks the prevention of insider trading. Rules and procedures governing the acquisition of corporate control and extraordinary transactions are not clearly articulated and anti-takeover devices are not subject to shareholders scrutiny. Dissemination of information is a concern and shareholders might

have a hard time finding material information before the general meeting.

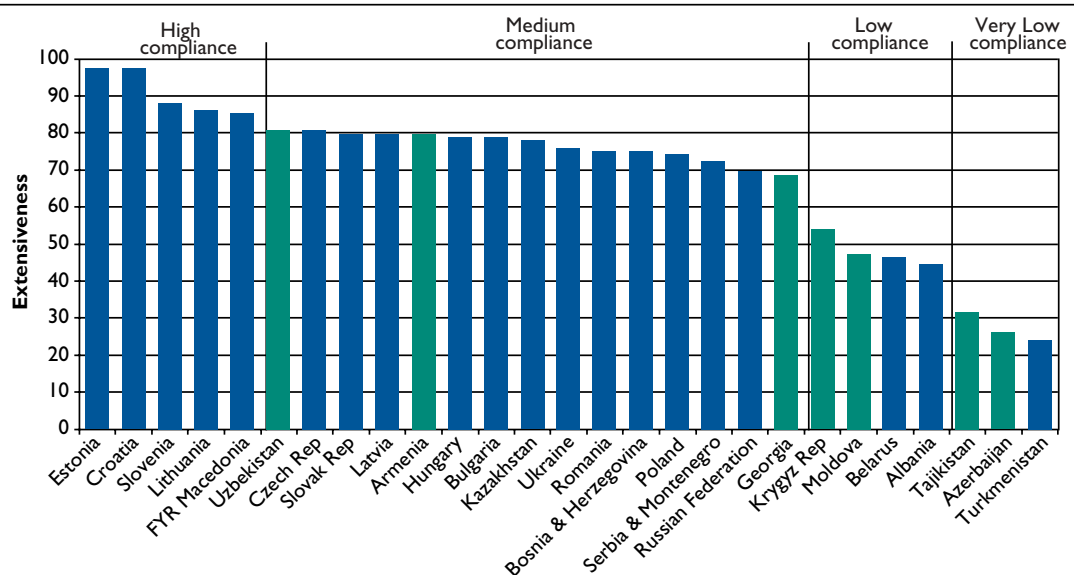
The law regulating securities markets and stock exchange was issued in 1992 and was amended further in 1998. Among the major shortcomings in the legislation, particular concern is given by the lack of provisions concerning protection of minority shareholders, disclosure of qualified shareholding and collective investment schemes. There are no professional accounting firms in the country although there are laws regulating accounting and bookkeeping activities. A stock exchange exists but it is not functioning.

In order to help Tajikistan implement corporate and financial governance reforms, the Asian Development Bank approved a technical assistance grant in early 2003. This technical assistance is aimed at strengthening the legal and regulatory framework for corporate and financial governance in commercial banks, supporting corporate sector development, enhancing institutional capacity for enterprise restructuring and formulating directions to guide the Government in corporate and financial governance and enterprise restructuring.

## Uzbekistan

In a better shape, Uzbekistan, rated 'medium compliance' in both assessments. The law on joint stock companies was enacted in 1996, based on the Russian model which conformed to the standards of market oriented system. In 2001, the Law on 'Companies with Limited and Additional Liability' extended the application of the standards applicable to joint stock companies to limited liability companies. Compared to the company laws of other CIS

**Figure 4: Extensiveness of securities markets legislation**



countries, Uzbek law seems to have a good basis for promoting sound corporate governance practice. However, room for improvement remains. In particular, dissemination of information should be improved and there are currently no requirements that shares should be fully paid before they can be transferred. Also regulation on insider trading should be enhanced.

Uzbekistan obtained the best compliance rate in the securities markets legislation assessment among ETC. The country introduced a new legislation on the regulation of investment intermediaries and information disclosure requirements for securities markets participants in 2002. In 2003 the country adopted regulations on the licensing of securities markets professionals, clearing and settlement, and stock exchange trading rules. Areas of improvement remain in further enhancing disclosure to shareholders during changes in corporate control, licensing of market intermediaries and in granting the power to take remedial actions to market authorities in case of market disruption.

## Georgia

Georgia rated 'low compliance' in the corporate governance assessment and 'medium compliance' in the securities markets one. Currently, corporate governance is mostly regulated by the Law on Entrepreneurs and to a lesser extent by the Law on Securities Market. The first was issued in 1994 based on the German model while the Law on Securities Market was approved in 1998 taking inspiration by the Anglo-American model. Both laws were amended in 2003 and some improvements were introduced. All joint stock companies are now subject to stricter disclosure and reporting requirements and the powers of the National Securities Commission of Georgia have been increased. Notwithstanding the past amendments, a need for improvement remains. In particular, the legislation on share registration is not always clear and this might cause uncertainty on share ownership. Provisions concerning the shareholders vote on anti-takeover devices by the board of directors should also be introduced and dissemination of company information improved. Particular attention should be paid to giving the board more responsibility for monitoring conflicts of interest of management, board members and shareholders, including misuse of corporate assets; the board should also be entrusted with the monitoring of governance practices under which it operates. Board independence should be introduced as a concept and properly monitored.

Results from the assessment on securities market legislation show a situation where many improvements need to be made. In particular, attention should be given to secondary market's

requirement for monitoring and supervision of the trading system and front-running practices. Furthermore, specific legislation concerning collective investment schemes should be issued and mechanisms to monitor large exposures, to protect customers' trades and positions in case of intermediary's insolvency emergency and procedures in case of system failure introduced.

## Kyrgyz Republic

The Kyrgyz Republic adopted a new law on joint stock companies in 2003, which was substantially amended in August 2004, improving the disclosure and transparency requirements for share depository, strengthening the position of the auditing committee in the company, providing clarification on the authority of the board of directors, defining new procedures for the approval of large transactions and introducing cumulative voting procedure for the appointment of the board of directors. However, several problems still remain. General reform priorities should aim to enhance effective implementation and enforcement of existing legislation, while continuing to reform existing regulations.

Also the Kyrgyz capital markets framework should be improved. In particular, disclosure requirements from issuers and large shareholders should be enhanced and legislation concerning collective investment schemes and mandatory takeovers bids introduced. In order to improve investors' confidence in the market, the introduction of an investor compensation scheme should be considered and capital adequacy, liquidity and insolvency requirements for intermediaries should be strengthened. Finally, specific legislation addressing money laundering should be enacted.

With the aim to improve the Kyrgyz securities markets framework, the EBRD is considering implementing a technical cooperation project in 2005 in order to enhance provisions concerning investor protection, transparency and disclosure in the capital market.

## Moldova

The very good rate obtained by Moldova in the corporate governance assessment is evidence of the extensiveness of its commercial legislation. The law on joint stock companies was adopted in 1997 and has been amended several times in order to improve the original structure. However, Moldova is a country where the Government is facing serious problems in effectively enforcing its corporate governance legislation. For example, disclosure of significant ownership is required, but due to the nominee ownership allowed by the law, the effective

disclosure of beneficial ownership and control structure is a key concern. Insider trading is prohibited by law, but so far there have been no sanctions or prosecutions for insider trading. A major weakness in the legal framework is the absence of any requirements that the board should treat all shareholders equally. Moreover, the board of directors has the authority to increase the capital and issue shares without the shareholders vote, which might cause dilution of minority. Finally, policymaker should consider re-introducing the recently abrogated provision mandating an independent audit for all joint stock companies.

Major shortcomings have been evidenced in the securities market legislation. Legislation does not require segregation of assets in collective investment schemes and there are no auditing requirements in relation to their assets; the role of the depository is not clear and valuation and unit prices are not regularly disclosed. Further, there are no provisions in place against front running, no mechanisms for identification of large exposures and no contingency plan or emergency procedure in case of market disruption or system failure. Finally the resources of the National Securities Commission could be enhanced further by providing the authority to issue sanctions capable to discourage unlawful market practices.

## Armenia

Compared with other countries in the region, the Armenian corporate governance framework results generally in line with international principles, mostly due to substantial assistance in reforming the existing legal framework offered by several international organisations. However the corporate law framework needs improvement in the shareholders registration issue and in enforcement of shareholders rights. Major problems remain in the securities markets where the country does not yet have a law to legitimise the establishment of collective investment vehicles nor does it have such vehicles in operation. Further problems also arise from the lack of harmonisation among different laws which can cause uncertain interpretation on different issues.

## What next?

As mentioned above, considerations expressed in this article are based on the assessment of the relevant legislation as it is on the books rather than its actual implementation and therefore the perception that practitioners and investors might have on a specific country's situation might be different. In order to measure the effectiveness of laws (i.e. how well the corporate governance regime

works in practice), this year the EBRD is planning a Legal Indicator Survey on corporate governance in all 27 countries of operation. Again, the aim of the initiative is to enhance policy dialogue and encourage, influence and provide guidance to governments, policy makers and all those involved in the existing and future development of corporate governance related legal reform in the region.

Finally, it is worth noting the discussions currently taking place under the auspices of the CIS Inter-Parliamentary Assembly, related to the development of the CIS Investor Protection Model Law. This standard setting initiative, sponsored by the EBRD, is intended to serve as a reference, containing recommendations and model legislative provisions for the CIS member states to use in their national legislation when they upgrade their respective national laws. The draft law based on international standards and best practices has passed the first reading in December 2004 and is scheduled for approval in spring 2005.

### Notes:

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- <sup>2</sup> For more information about the EBRD's Legal Transition Programme, please refer to "<http://www.ebrd.com/country/sector/law/about/main.htm>"
- <sup>3</sup> The corporate governance assessment results can be accessed at <http://www.ebrd.com/country/sector/law/corpgov/assess/main.htm> . The securities markets legislation assessment results can be accessed at "<http://www.ebrd.com/country/sector/law/corpgov/sml/main.htm>"
- <sup>4</sup> For more information on the ETC Initiative, please refer to <http://www.ebrd.com/country/sector/law/etc/main.htm> and "<http://www.ebrd.com/pubs/law/lit/04a/main.htm>"

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