

# The role of the EBRD in promoting sound corporate governance

In recent years, various organisations and interest groups have been promoting corporate governance standards. Institutional investors have been promoting a corporate governance model focused on the interests of shareholders. These efforts were mainly directed at strengthening influence and control of management action. Other constituencies have stressed the broader responsibilities of enterprises towards their various stakeholders in addition to shareholders, including employees, suppliers, the community in which they operate, as well as local and national governments. The EBRD advocated, in 1997, corporate governance principles that recognised the set of relationships between shareholders, board, management and other constituencies of a company.<sup>1</sup>

Following the financial crises in East Asia, the Commonwealth of Independent States (CIS) and South America, the articulation of sound corporate governance standards has become an issue of acute concern. In response, the Organization of Economic Co-operation and Development (OECD) coordinated and led the development of a comprehensive set of corporate governance principles to serve as the primary guidance in this area.<sup>2</sup>

As a major lender and investor in enterprises domiciled in the countries of central and eastern Europe and the CIS, the European Bank for Reconstruction and Development (EBRD or Bank) has always sought to improve corporate governance standards. Improving the corporate governance system of its investee companies is consistent with the EBRD's commitment to apply sound banking principles in all its financial operations. The Bank is also determined to ensure that all its operations have "transition impact", i.e., they contribute to the transformation of its countries of operations from centrally planned economies to market economies, and by insisting on good corporate governance the EBRD assists the transition process. For a large part of the 20th century, enterprises in transition countries responded primarily to the demands of planning agencies. Many enterprises have only recently become exposed to the genuine interests of shareholders and other stakeholders.

The EBRD is also active beyond its purely financial operations. Good corporate governance depends on the broader legal and regulatory environment prevailing



in the country of domicile of a given company. Through various law reform initiatives in its countries of operations, the EBRD seeks to address these broader aspects of corporate governance.

### The need for an incentive framework for corporate governance

Good corporate governance requires internal control mechanisms and policies, including means to ensure that staff act in the interest of the enterprise and do not engage in insider dealing, disclose proprietary information or provide credit on grounds other than objective assessments of potential returns and risks. Maintenance of good institutional governance also requires that owners, directors and senior management are subject to appropriate sanctions in the event that they disregard standards of good corporate behaviour. Good institutional governance is more likely to be sustained if financial stakeholders (i.e., minority shareholders, creditors, depositors) bear some of the cost and effort of exercising diligent corporate oversight.

In fully developed capital markets, bondholders and minority shareholders share a keen interest in exercising corporate oversight. Likewise, banks in such markets will operate effective systems for counterparty appraisal and exposure control. This also applies to developed interbank markets, where the prospect for poorly managed banks of reduced credit lines and increased risk charges serve as powerful incentives for good corporate behaviour. Finally, a key feature of effective corporate governance systems is that poorly run commercial enterprises, including financial institutions, must be allowed to fail. An effective insolvency regime requires adequate legislation and effective judicial and administrative mechanisms.

Shareholders and creditors alike must understand and be satisfied with the manner in which financial stakeholders can oversee

the performance of management and participate in key decisions. As a minimum, the charter of a company should set out the basic roles and responsibilities of the various corporate bodies such as the general assembly, the supervisory board or board of directors. In addition, shareholder rights must be protected against dilution or other loss of value through inappropriate dealings and transfer pricing. The integrity of the shareholders' registry must be assured. Protection of shareholders' rights also requires the distribution of an annual report containing properly audited accounts and other important corporate information.

### Towards international standards of corporate governance: OECD Principles of Corporate Governance

The OECD has been active in the area of corporate governance for a number of years, beginning in 1996 with the commissioning of a study of corporate governance. The study, which reviewed and analysed international corporate governance issues and suggested an agenda and priorities for further OECD initiatives, led to the establishment of the Business Sector Advisory Group on Corporate Governance.<sup>3</sup>

The OECD Council, meeting at ministerial level on 27 to 28 April 1998, called upon the OECD to develop, in conjunction with national governments, relevant international organisations and the private sector, a set of corporate governance standards and guidelines. In order to fulfil this objective, the OECD established the Ad-Hoc Task Force on Corporate Governance to develop a set of non-binding principles that embody the views of OECD member countries on this issue.

The principles contained in the resulting document<sup>4</sup> (the OECD Principles) are built upon the experience gained from national initiatives in OECD member countries and previous work carried out within the OECD, including that of the OECD Business

<sup>1</sup> EBRD, *Sound Business Standards and Corporate Practices: A Set of Guidelines* (September 1997), available at the EBRD website at [www.ebrd.com](http://www.ebrd.com).

<sup>2</sup> For details, see the OECD website at [www.oecd.org](http://www.oecd.org). For discussion of the emerging international standards-setting process and its components, see J. Norton, "International financial law and international economic law: implications for emerging and transitioning economies", *Law in Transition* (EBRD, London, Spring 1999), p.2; G. Sanders and D. Arner, "The legal anchoring of sound financial markets", *Law in Transition* (EBRD, London, Spring 1999), p.18; EBRD, *Transition Report 1998* (EBRD, London, November 1998), ch.6.

<sup>3</sup> *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*, a report to the OECD by the Business Sector Advisory Group on Corporate Governance (OECD, Paris, 1998).

<sup>4</sup> OECD, *Principles of Corporate Governance*, SG/CG(99)5 (OECD, Paris, April 1999) (available at [www.oecd.org](http://www.oecd.org)).

Sector Advisory Group on Corporate Governance. Several OECD committees contributed to the preparation of the OECD Principles, as well as non-OECD countries, the World Bank, the International Monetary Fund, business groups, investors, trade unions, and other interested parties. The EBRD participated in the meetings of the Task Force on Corporate Governance as an observer.

The OECD Principles seek to strike a balance between the various, sometimes conflicting, concepts of corporate governance, and promulgate standards of good corporate behaviour under five main headings: the rights of shareholders, equitable treatment of shareholders, the role of stakeholders, disclosure and transparency, and responsibility of the board.

The core values underlying the OECD Principles are fairness, transparency, accountability and responsibility. It is hoped that the OECD Principles will find universal application, and will thus facilitate the development of corporate governance systems based on these core values throughout the world.

The OECD Principles were adopted by the OECD Council in May 1999. Further, on 21 June 1999, the OECD and the World Bank entered into a Memorandum of Understanding envisaging co-operation between the two organisations for the promotion of the OECD Principles in non-OECD countries.<sup>5</sup> (See the Legal Transition Events section in this issue for a further description of this co-operation.)

### EBRD activities that foster good corporate governance

The EBRD was established in April 1991 in response to the unprecedented changes and challenges arising from the central and eastern European countries' move from centrally planned and command economies to democratically governed market economies. The Bank was given the mandate to support this transformation through the promotion of private and entrepreneurial initiative in these countries.<sup>6</sup>

The EBRD accomplishes its mandate primarily by the financing of specific projects that have a positive impact on the process of transition. The Bank's operational objectives place primary emphasis on programmes that support privatisation and the development of a competitive private sector, with particular emphasis on investment in infrastructure.<sup>7</sup> The EBRD is required to operate in accordance with sound banking principles.<sup>8</sup> At the same time, the EBRD's operation is required to be "additional": i.e., it is barred from undertaking any financing where a borrower or client applicant is able to obtain sufficient financing or facilities elsewhere on terms and conditions that the Bank considers reasonable.<sup>9</sup> Within these constraints, the EBRD carries out its operations in the following principal ways, in accordance with its mandate:<sup>10</sup>

- providing loans to private sector enterprises and state-owned enterprises operating competitively to facilitate their transition to private ownership and control;
- investing in equity capital of private sector enterprises, or state-owned enterprises operating competitively to facilitate their

- transition to private ownership and control;
- underwriting equity and debt issues of securities;
- facilitating access to domestic and international capital markets by enterprises through the provision of guarantees and financial advice;
- providing technical assistance for the reconstruction or development of infrastructure.

### Sound business standards and corporate practices – a set of guidelines

As an international institution with the mandate to assist the transition process in the countries of central and eastern Europe and the CIS, the EBRD views the promotion of sound standards of business conduct as central to its work. The Bank published a set of guidelines in September 1997 to help companies understand some of the broader concerns that lenders and investors have when considering a potential loan or investment opportunity in the region.<sup>11</sup>

The guidelines seek to address concerns of general importance for any investor or lender, and therefore discuss areas of concern to the EBRD when it evaluates investment and lending opportunities. The guidelines cover not only fundamental interests of all shareholders, but also the relationship between companies and their clients, suppliers, local communities and governments. Sound principles of corporate governance include the existence of a transparent shareholding structure, respect for the rights of minority shareholders and a well-functioning board of directors.

The success of a company in the long term depends not only on the quality of its strategy, competent management, valuable assets and a promising market. Success also hinges on the quality of the relationships that the company maintains with the various constituencies on which it depends: customers, shareholders, lenders, employees, suppliers, the community in which it operates, government and local authorities.

Sound and stable relationships depend on fair, transparent and responsible practices, behaviour and standards. Thus the long-term success of a company and its ability to attract capital depends on establishing and meeting these standards.

An essential underlying theme of the guidelines is the prevention of financial fraud and avoidance of corruption. As the guidelines emphasise, it is incumbent upon companies to promote sound business practices through their own behaviour. For example, company boards are encouraged to adopt a code of ethics for their company, and executive managers are encouraged to motivate employees and associates to adhere to this code.



### Raising awareness of reform needs

The EBRD seeks to raise awareness of policy makers and other interested parties about the legal, regulatory and market environment underpinning good corporate governance in its countries of operations, in order to stimulate reform. The Bank also provides law reform assistance to government agencies.

The EBRD's Office of the General Counsel recently conducted a survey about capital markets and banking supervision laws in the EBRD's countries of operations, which sought to assess to what extent the laws of these countries approximate international standards.<sup>12</sup>

With regard to banking laws, survey participants were asked to answer survey questions based on the Basle Committee on Banking Supervision's *Core Principles for Effective Banking Supervision*<sup>5</sup> in an effort to ascertain the extensiveness and effectiveness of the banking laws of their countries in relation to the relevant international standard. As to capital markets laws, the International Organization of Securities Commission's *Objectives and Principles of Securities Regulation*<sup>6</sup> were chosen as the most appropriate benchmark.

Laws were rated for extensiveness and effectiveness based on the survey responses, as "fully", "strongly", "moderately", "weakly" and "non-conforming" with the respective benchmarks. According to the survey results, none of the jurisdictions was rated as "fully conforming" in the area of either banking or capital markets law. The capital markets laws of five countries were rated as "strongly conforming", several countries were rated as "weakly conforming", and twelve countries were rated as "non-conforming". In the banking supervision area, four countries were rated as "strongly conforming", several countries as "weakly conforming" and seven countries as "non-conforming".

As a result of this empirical approach, the Bank is raising the profile of issues of legal reform in the region, including in the area of corporate governance, and is able to focus its own efforts and resources on areas of most significant need. (See the following article for an analysis of survey results focusing specifically on corporate governance practices.)

#### Providing legal technical assistance

In the area of corporate governance, the Legal Transition Team of the EBRD is currently providing legal technical assistance to the Russian and Czech securities commissions. Legal technical assistance projects for other countries supporting good corporate governance are in preparation. Moreover, the EBRD's Legal Transition Programme, which combines all its legal

reform initiatives, focuses not only on company law and securities regulation, but also on other areas of the law that are important corollaries to good corporate governance, such as bankruptcy laws and secured transactions laws.<sup>7</sup>

#### **Russia: reform of law on joint stock companies**

The EBRD is currently assisting Russia's Federal Commission for the Securities Market (FCSM) in improving the legal framework for good corporate governance. The Bank's legal reform project, funded by the Japanese Government, aims to facilitate and promote a well-organised, modern, efficient capital market in the Russian Federation, and helps to achieve higher standards in regulation of corporations and protection of rights of securities holders.

On the whole, the Russian Law on Joint Stock Companies, which came into force on 1 January 1996, has provided a solid legal framework for corporate activity. However, its implementation has shown some obvious gaps and some of its provisions require further adjustment or adaptation. The vital legislative supplements needed to modernise Russian corporate law include procedures governing the liability of directors and managers, external and internal audits, transactions with affiliated or connected persons and general and special meetings.

The only federal law directly concerning the Russian capital market is the Law on the Securities Market, which became effective on 25 April 1996. Other applicable rules are contained in regulations issued by the FCSM, and in presidential decrees. However it has become apparent that rapid development of the Russian securities market is inadequately served by the current legal system, and improved rules are needed to avoid legislative gaps, lack of clarity and resulting uncertainties for market participants. The inadequacy of the present legislative framework affects the relations between market participants and the willingness of potential investors to enter the market. It also prevents the FCSM from

<sup>5</sup> *Memorandum of Understanding between the World Bank and the OECD, A Framework for Co-operation between the Organization for Economic Co-operation and Development and the World Bank* (Paris, 21 June 1999) (available at [www.oecd.org](http://www.oecd.org)).

<sup>6</sup> *The Agreement Establishing the European Bank for Reconstruction and Development*, Art.1.

<sup>7</sup> See Art.2.

<sup>8</sup> Art.13(i).

<sup>9</sup> See Art.13(vii), providing: "the bank shall not undertake any financing, or provide any facilities, when the applicant is able to obtain sufficient financing or facilities elsewhere on terms and conditions that the Bank considers reasonable".

<sup>10</sup> See Art.11.1.

<sup>11</sup> See EBRD, *Sound Business Standards and Corporate Practices: A Set of Guidelines* (September 1997), available at the EBRD website at [www.ebrd.com](http://www.ebrd.com).

<sup>12</sup> The results of the survey and discussion of its methodology are presented in A. Ramasastry and S. Slavova, "Market perceptions of financial law in the region – EBRD survey results", *Law in Transition* (EBRD, London, Spring 1999), p.24, and *Transition Report 1998* (EBRD, London, November 1998), ch.6. The spring 1999 issue of *Law in Transition*, the legal publication of the EBRD, contained a "Focus on financial markets".

<sup>13</sup> Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (BIS, Basle, 1997).

<sup>14</sup> International Organization of Securities Commissions (IOSCO), *Objectives and Principles of Securities Regulation* (IOSCO, Montreal, 1998).

<sup>15</sup> For this reason, legal reform in the area of insolvency is an important focus of the EBRD, and, as in previous years, the EBRD's Office of the General Counsel has analysed insolvency within the context of its survey of commercial law extensiveness and effectiveness, presented in the annual *Transition Report* since 1996. For an explanation of EBRD survey practice, see J. Taylor and F. April, "Fostering Investment Law in Transitional Economies: A Case for Refocusing Institutional Reform", 4 *Parker School Journal of East European Law* (1997), p.1.

applying enforcement measures against market participants acting in bad faith, but avoiding violations of the present legislative framework.

To boost investors' confidence, the FCSM has initiated a State Programme for Protection of the Rights of Investors. The Programme aims to protect minority shareholders and to improve corporate governance standards. It encompasses 17 laws and regulations that the FCSM will develop. Within the overall framework of the Programme, the EBRD's Legal Transition Team provides technical assistance in respect of amendments to the Law on Joint Stock Companies in the following general areas: general meetings, external and internal auditors, board (including independent directors) and executive management. Such assistance will further clarify the roles and obligations of Russian directors and management towards the protection of shareholders' rights.

#### ***Czech Republic: reform of securities regulation and strengthening minority shareholder rights***

The EBRD is currently undertaking a legal technical assistance project to provide support to the Czech Republic in establishing a securities commission (the Czech SEC) for the supervision and regulation of the Czech capital markets. One of the primary objectives of this project, funded by EU Phare, is to provide assistance in institutionalising a regulatory authority which will enable the Czech capital markets to function in an efficient, fair and transparent manner, thus increasing the level of confidence of the investor community.

More specifically, this project is designed to achieve the following:

- the development of regulations and procedures for the proper functioning of the Czech SEC;
- the development of regulations and procedures (e.g., licences and licensing procedures) for use by the Czech SEC in order to ensure fairness, transparency, efficiency and consistency in the exercise of its powers;

- the development of an appropriate organisational and management structure as well as operating systems and procedures for the Czech SEC; and
- training for commissioners and other Czech SEC staff on matters related to the functioning of the Czech SEC.

It is intended that the project will contribute to the establishment of a functioning regulatory authority, which in turn will support the development of the Czech capital markets into an increasingly important source of long-term finance for private sector companies. As such, the project will have a significant impact on raising the standards of corporate governance in the Czech Republic by improving the transparency of Czech capital markets and ensuring that Czech companies are subject to rigorous oversight by the SEC.

#### ***Improving corporate governance in equity and debt transactions***

The EBRD seeks to address corporate governance issues directly in the context of its financial transactions.

##### ***Equity investments***

As an equity investor, the EBRD is concerned that it obtains comprehensive, reliable information about the affairs of its investee companies. Therefore, the Bank insists that the financial statements of its investee companies are prepared in accordance with International Accounting Standards or other accounting standards of broad recognition, and that financial statements are audited by independent auditors acceptable to the EBRD.

The EBRD is also concerned about the integrity and transparency of the affairs of its investee companies. Accordingly, it conducts an integrity due diligence prior to making an investment, and its transaction documents are designed to ensure that investee companies are and remain in compliance with applicable laws. The EBRD is also determined to prevent fraud and corruption in its investee

companies, and it does not tolerate payment of kickbacks and other illicit pay-offs.

In its equity investment operations, the EBRD always takes minority shareholding positions, and is therefore keen to promote corporate governance arrangements protecting the interests of minority shareholders.

In particular, the Bank insists on:

- the integrity and reliability of shareholder registries;
- the absence of inappropriate transfer pricing schemes;
- the approval of major corporate transactions and restructuring by a qualified majority;
- the exclusion of interested shareholders from voting decisions regarding matters on which they have a conflict of interest; and
- the arm's-length procurement arrangements.

The EBRD seeks to reflect these principles in charters of its investee companies, for example, or in shareholder agreements to which the Bank is a party.

The EBRD also aims to improve corporate governance standards in its investee companies by nominating, as members of the boards of these companies, individuals experienced in good corporate governance.

##### ***Debt investments***

As a lender, the EBRD seeks to implement principles of good corporate governance through standard provisions in its loan agreements (representations, warranties and covenants). Specifically, under the terms of the loan agreement, the borrower represents and warrants to the Bank that:

- the financial statements (balance sheet and income statements) are prepared in accordance with International Accounting Standards or another set of broadly recognised accounting principles;
- the financial statements have been audited by independent auditors acceptable to the EBRD;
- the financial statements present the true and fair view of the borrower's financial

- position, and include all material contingencies and financial commitments;
- the borrower is in compliance with all applicable laws, including environmental, health and safety laws, has filed all tax returns, and has paid all required government charges; and
  - neither the borrower nor any of its officers, directors, employees, agents or representatives has paid, promised or offered to pay, or authorised payment of, any commission, bribe, pay-off or kickback related to the project.

Moreover, the borrower covenants to the EBRD that it will:

- maintain its corporate existence and will conduct its business in accordance with all applicable laws;
- conduct its business with due regard to the environment, health and safety;
- maintain its accounts in accordance with the agreed accounting standards, and will maintain auditors acceptable to the EBRD;
- maintain all governmental approvals required for its business;
- conduct all its dealings on ordinary commercial terms, and on the basis of arm's-length arrangements, and will not enter into transactions whereby the borrower would pay more than the commercial price for any purchase or would receive less than the full commercial price (subject to normal trade discounts) for its products or services;
- not enter into any partnership, profit-sharing or royalty agreement or other arrangements whereby the borrower's income or profit is shared with another person without the EBRD's consent; and
- not sell substantially all its assets, merge with another entity or carry out a reorganisation without the EBRD's consent.

#### Improving corporate governance in work-outs

In work-outs, the EBRD seeks to promote good corporate governance by insisting on fair and equitable treatment of all financial

stakeholders. Where there is no prospect of continued financial viability of a borrower or investee company, the EBRD promotes the orderly liquidation and fair distribution of the liquidation proceeds in accordance with applicable law.

#### Conclusion: next steps

The EBRD is committed to continuing and reinforcing its promotion of good corporate governance in its countries of operations. As in the past, it will emphasise the importance of good corporate governance in its legal reform projects and other investment climate work with the governments of its countries of operations, and through its role as a prominent investor and lender.

The EBRD has recently started work on the development of a checklist to aid its lawyers and bankers in the systematic evaluation of the governance practices of the Bank's countries of operations and potential investee companies. In future, this checklist may be supported by model charter provisions, which will serve as a benchmark for its bankers and lawyers in their work with prospective EBRD clients. In addition, the EBRD will continue to participate in international initiatives in the area of corporate governance, such as the Global Corporate Governance Forum recently initiated through agreement between the OECD and the World Bank. [🔗](#)

\* In connection with the preparation of this article, the author gratefully acknowledges the assistance of Douglas Arner, Sir John Lubbock Fund Fellow in International Capital Markets Law, Centre for Commercial Law Studies, Queen Mary and Westfield College, University of London.

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