Law in transition
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Corporate governance
Foundation for capital flows

Banks and bankruptcy in Russia
New restructuring and insolvency laws

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Corporate governance as a foundation of capital flows

Sound corporate governance practices are a cornerstone for attracting investment

As an international financial institution with a mandate to promote private sector development, the EBRD has special reason to be concerned with the issue of corporate governance. As one of the largest lenders and investors in central and eastern Europe and the Commonwealth of Independent States, the EBRD must satisfy itself that enterprises and financial institutions in receipt of Bank financing are properly organised under domestic legislation and that their treatment of shareholders, customers, suppliers and other stakeholders is transparent and complies with that legislation. Under the Agreement Establishing the Bank, the EBRD’s equity investments are limited to a minority position. The Bank is, therefore, particularly concerned with how its investee companies treat their shareholders and whether minority shareholders are able to have their legal rights enforced effectively.

These concerns led the EBRD to take an early, proactive approach to the development and enforcement of sound principles of corporate governance in all its countries of operations. In September 1997, before the recent financial crises raised the profile of corporate governance among international investors and lenders, the EBRD published its own set of corporate governance guidelines, Sound Business Standards and Corporate Practices. The objective of these guidelines was to help companies and governments understand the broader concerns of lenders and investors. The guidelines served as a precursor to the recently published OECD Principles of Corporate Governance. This issue of Law in transition is a continuation of the Bank’s efforts to keep corporate governance high on the agenda of our sponsors, clients and countries of operations.

The EBRD takes a two-pronged approach to promoting corporate governance, as described in the article by the Bank’s Deputy General Counsel, Norbert Seiler. Through integrity checks and the terms and conditions of its investment operations, the Bank assesses and influences the internal structure and operation of those enterprises to which it intends to lend or invest. Sound corporate governance and the integrity of an enterprise will continue to be an integral component of the EBRD’s due diligence exercise before it makes any financial commitment.

Through its Legal Transition Team, the EBRD fosters the appropriate external environment – an extensive and effective legal and regulatory framework - supporting sound corporate governance practices. For example, the Bank is assisting the Czech Securities and Exchange Commission and Russia’s Federal Commission for the Securities Market to expand their securities laws and strengthen enforcement powers. As noted in the article by Rodney Insall, BP Amoco’s Vice President for Corporate Governance, this framework both defines shareholder and creditor rights and creates and empowers the institutions necessary for their effective enforcement. Several articles in this issue note that the existence of a strong legal framework supporting sound corporate governance practices is a key factor in the decisions made by portfolio investors (such as the California pension fund CalPERS) and foreign direct investors. The Bank also places corporate governance practices on the agenda of its ongoing dialogue with government and business leaders in the region, to impress upon them the importance of good corporate governance practices to secure EBRD and other financing.

The articles in the focus section of this issue of Law in transition elaborate the importance of sound corporate governance principles and practices in attracting the long-term capital flows necessary to support economic growth and development.

This issue also addresses other important legal transition subjects. Following on from the focus on financial market regulation in the last issue, there is an article from Michael Taylor of the IMF on best practice standards for banking and securities regulation and their application to transition economies. This issue also contains one of the first descriptions and assessments of the new legal and regulatory structure crafted to deal with Russia’s banking crisis. With the second of her articles on recovering debt in Russia, Mira Davidovski, a partner at Salans Hertzfeld & Heilbronn, provides a guide to operating under Russia’s new bank insolvency and bank restructuring laws.
International financial standards and the transition economies

In recent years, best practice standards for banking and securities regulation have been promulgated by the leading international groupings in these fields. This article reviews the rationale behind these documents and considers their application to the specific environment of the transition economies.

Within the last two years, the main international organisations of banking and securities regulators have separately promulgated best practice standards for the guidance of national regulatory bodies. The first set of standards to be issued were the Basle Committee on Banking Supervision’s Core Principles for Effective Banking Supervision (the “Core Principles”), which were issued as a consultative document in May 1997 and adopted at the annual IMF/World Bank meeting in Hong Kong the following September. Following the adoption of the Core Principles, the International Organization of Securities Commissions (IOSCO) began work on their own statement of the Objectives and Principles of Securities Regulation (the “Objectives and Principles”), which were formally adopted by the organisation at its 23rd Annual Conference in September 1998. Both the IOSCO Objectives and Principles and the Basle Committee’s Core Principles have a shared purpose in that they aim to provide “a yardstick against which progress towards effective regulation can be measured.”

They are also similar in that both set out a number of detailed principles which are intended to be a statement of current best practice in the design and operation of regulatory regimes for their respective fields.

Another important feature of both documents is that they are intended to be of general application, and should in theory be of greatest value to the developing and transition economies that are currently attempting to develop their regulatory systems. Although the Basle Committee is a grouping of G-10 central banks and bank regulators, its Core Principles are not intended to be restricted to the G-10 countries, and it took the unusual step of co-opting a number of emerging market regulators into its deliberations. Indeed, the Core Principles’ adoption at the IMF/World Bank Annual Meeting in 1997 and their subsequent endorsement at the biannual international meeting of bank supervisors in 1998 demonstrates that they are intended to apply to both developing and developed markets. Unlike the Basle Committee, IOSCO’s membership has a genuinely international scope, comprising 152 agencies from 88 countries (November 1997 figures). Its Objectives and Principles are intended to be the counterpart to the Core Principles in providing a reference document of best practice for securities regulators for the emerging and developed markets.

However, the question remains whether these documents will be able to perform the important function for which they have been designed. In particular, the extent to which it is possible to transpose a set of principles evolved in the developed markets into the very different conditions of the developing and transition economies has yet to be examined. This article therefore falls naturally into two parts.

The rationale for international financial standards

1. Banking regulation

Although the need for international standards for banking and securities regulation might be thought to derive from the same source, in reality there are important differences in the motivation for, and justification of, the two documents. The Core Principles paper explains its purpose in terms of the potential for “weaknesses in the banking system of a country … [to] threaten financial stability both within that country and internationally.”

In other words, the primary concern of banking regulators is with financial stability. Major banking sector problems can affect financial stability both in a domestic context and internationally, and the domestic costs of recent banking sector bailouts have been substantial. According to a survey conducted by an IMF team, 133 out of 181 Fund members suffered either “significant problems” or a “crisis” in their banking sectors between 1980 and spring 1996. During this period 41 crises in 36 countries were identified. The effects on the real...
In one jurisdiction to trigger serious problems in the international payments system, illustrated most clearly by the closure of Bankhaus Herstatt in 1974. Payment systems risks are increasingly internationalised, as are other linkages between banks, especially in the interbank market. One of the root causes of the East Asian crisis was short-term lending by developed world international commercial banks to poorly-supervised local banks. Once the East Asian crisis developed, the extent of these exposures was sufficient to impair the capital strength of several developed world international commercial banks. These inter-linkages mean that there is a very strong incentive for bank regulators to ensure that all countries are responsible for authorising and supervising banks to adhere to a set of common minimum standards, such as those contained in the Core Principles.

2 Securities regulation

By contrast, securities regulators have not traditionally shared the bank regulators’ concern with financial stability. This follows from the nature of the risks that arise in the securities business, and the balance sheet structures of securities firms. The assets of a securities house, unlike those of a bank, mainly comprise marketable securities which can be sold when the firm encounters funding difficulties. In other words, there is not the same mismatch between the liquidity of assets and liabilities which characterises economies and fiscal systems of those countries were generally severe. The costs of restructuring banking systems as the result of major crises have varied between 4.5 per cent of GDP in Norway and Sweden in 1991 and 19.6 per cent of GDP in China in 1985. In the United States the costs of resolving the Savings and Loan crisis of the late 1980s are estimated to have amounted to 5.1 per cent of GDP. Although both developed and developing countries have experienced banking crises, a disproportionate share of them has occurred in the developing markets, where their effects on macroeconomic conditions have generally been more severe.

One factor shared by the otherwise very different developing countries is that they are engaged in the process of modernising and liberalising their financial systems. This does not in itself present an argument against financial liberalisation, but it does show that financial reform is likely to impose additional stresses on banking systems. Financial reform can thrust additional and unfamiliar responsibilities on bank management and regulators alike. The greater competition which results from liberalisation can erode franchise values and profitability built up in cartelised markets, and can lead to excessive risk-taking by management unfamiliar with the trade-off between return and risk in the new world of competitive markets. Financial liberalisation can itself result in macroeconomic volatility and asset-price fluctuations, which can be damaging to banks’ balance sheets – for example, as a result of over-investment in particular sectors such as real estate or commercial property.

To these general factors can be added other, more properly institutional factors specific to the developing and transition economies. These include excessive government ownership of, and involvement in, the banking sector, and poorly designed official safety nets which encourage excessive risk-taking by bank owners and managers in the belief that they will be bailed out. Connected lending in the form of loans to bank owners and managers and their related businesses results in a high concentration of credit risk and a lack of objective credit assessment. Regulatory forbearance – especially in the form of allowing insolvent institutions to remain open – can also result from intense political pressure in these environments, although in the long run its main effect is to increase the costs of resolving a banking crisis.

In this environment there is a clear need to ensure that systems of banking regulation and supervision are sufficiently robust to withstand the additional strains imposed by financial liberalisation. The concept of the Basle Core Principles is to provide a compendious guide to current best practice in bank regulation, to enable banking regulatory systems to be strengthened to meet the additional challenges of financial liberalisation. Thus, as part of their response to the East Asian crisis, both the IMF and World Bank have engaged in technical assistance work to improve the quality of banking regulation in the emerging markets using the Core Principles as a guide. This work involves designing regulatory regimes in which regulators have sufficient powers and resources (both human and financial) to discharge their tasks adequately; it also means devising incentive-compatible deposit insurance schemes, and making provision for the orderly exit of unsound banks. Each of these features of a regulatory regime is examined in the Core Principles.

However, improving the standards of bank regulation in the emerging and transition economies to help avoid a serious banking crisis is not simply of domestic benefit to those countries. A second important motivation for encouraging adoption of the Core Principles is the recognition that supervisory weaknesses in one national jurisdiction can result in problems that can rapidly spill over into others. This reflects the traditional concern of bank regulators about the potential for the collapse of a weakly capitalised bank in one jurisdiction to trigger serious problems in the international payments system, illustrated most clearly by the closure of Bankhaus Herstatt in 1974. Payment systems risks are increasingly internationalised, as are other linkages between banks, especially in the interbank market. One of the root causes of the East Asian crisis was short-term lending by developed world international commercial banks to poorly-supervised local banks. Once the East Asian crisis developed, the extent of these exposures was sufficient to impair the capital strength of several developed world international commercial banks. These inter-linkages mean that there is a very strong incentive for bank regulators to ensure that all countries are responsible for authorising and supervising banks to adhere to a set of common minimum standards, such as those contained in the Core Principles.

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a bank’s balance sheet. This has important implications, since it means that, in general, securities firms can be allowed to fail with little risk of loss to either investors or to the wider financial system. Provided that clearing and settlement systems are robust, that adequate margin has been taken by the clearing house, and that client assets have been properly segregated from those of the firm, then the failure of a market intermediary is unlikely to have serious ramifications for the financial security of the market, or significant spill-over effects in other markets.

The securities markets’ lack of contagion risk relative to the banking sector means that problems there are less likely to be either the source of significant dead-weight losses to the economy as a whole or the source of serious international instability. In terms of volatility in securities markets can affect financial stability, it would need to be intermediated through the banking system, as happened in the United States following the Great Crash of 1929. In this respect stock market volatility is arguably little different from volatility in other asset markets, especially the real estate sector. This analysis contrasts with that of the Emerging Markets Committee of IOSCO, in its report on the Causes, Effects and Implications of Financial and Economic Turbulence in Emerging Markets, which states that the events of 1997 “provided striking evidence of the power of financial contagion in today’s environment” and in particular of the potential for the disruption of orderly conditions in securities markets to occur on a cross-border basis. However, for reasons already explained, stock market volatility is not directly a cause of systemic problems and for this reason systemic stability should not be a key objective of securities regulation. Securities regulators can best help contain the potential systemic impact of the markets they regulate by ensuring their financial security. This includes, for example, paying attention to settlement and clearing systems, the capitalisation of market intermediaries, and market default procedures. Obviously, the reduction of systemic risk will be one corollary of this activity, but it is not its primary purpose. Indeed, the financial security objective is as much an issue of investor protection as it is of systemic protection.

These considerations imply that the financial stability objective, which is the guiding principle behind the Basle Core Principles, need not form a major component of the IOSCO Objectives and Principles. For this reason, the inclusion in the Objectives and Principles of the reduction of systemic risk as one of the three core objectives of securities regulation is misguided.

This is not to say that well developed securities markets cannot make a significant contribution to ensuring long-term financial stability. In recent years the Bretton Woods institutions have emphasised the importance of developing bond and equity markets as a way of reducing the financial fragility of emerging economies. The development of direct financing mechanisms is the form of stock and bond markets can serve to diversify risk within the financial system and can reduce the dependence of these economies on finance intermediated through banking systems. In addition, the greater use of bond and equity markets by emerging economies can also serve to reduce financial fragility in the developed world, by helping shift the exposure to the emerging economies from commercial banks to portfolio investors; had more of the risk in East Asia been borne by portfolio investors the contagion effects of the crisis might have been less pronounced. Lastly, the development of financial markets in the emerging and transition economies can also help to foster financial stability by providing mechanisms for risk transfer and hedging by banks. The problem to which the absence of hedging opportunities can give rise is also illustrated by the East Asian example: in this case banks compensated for their inability to hedge their interest rate risk by lending to their customers at floating rates. The overall effect of this was simply to make banks’ customers more vulnerable to the
sharp rises in interest rates which followed the authorities’ decision to allow their currencies to float freely.

While each of these factors is an important reason for seeking to encourage the long-term development of securities markets, they do not provide a justification comparable to that behind the development of international minimum standards for banking regulation: the fear of contagion risk. Instead, as the IOSCO Objectives and Principles paper itself states, the main objectives of securities regulators are less concerned with financial stability than with ensuring:

- the protection of investors, and
- that markets are fair, efficient and transparent.

The concept of investor protection as it appears in the Objectives and Principles paper is explained as follows: “The most important means for ensuring investor protection is the requirement of full disclosure of information material to investors’ decisions. Investors are, thereby, better able to protect their own interests.” In other words, the essence of securities regulation is to ensure that investors are placed in a position to make a fully informed judgement of the potential risk and return characteristics of a security. The principle of “freedom with disclosure” contrasts with the notion that it is in some sense part of the regulatory task either to substitute for the decisions of informed investors (for example by the “pre-approval” of securities issued) or to direct capital flows into specific channels. Hence, IOSCO’s investor protection principle implies a more market-based approach than has been typical of many jurisdictions, especially in the transition economies.

The second objective supports the first in that fair, efficient and transparent markets are ones in which the process of price discovery will operate on the basis of the information available to all investors. This objective concerns such matters as the authorisation of exchanges, ensuring a reliable price formation process, and the prevention of improper trading practices including market manipulation and insider dealing. The Objectives and Principles paper also states that regulation should promote the efficiency of markets, although market efficiency is not defined in the document. In practice, market efficiency should include both a concern with the competitiveness of a market (for example preventing anti-competitive behaviour with regard to the provision and pricing of broker/dealer services) and a concern with the market’s architecture as it affects the process of price discovery (for example issues of liquidity, thinness and variability).

The pursuit of these two objectives in increasingly internationalised financial markets necessitates greater cooperation between securities regulators than hitherto. The development of integrated capital markets has had at least three major implications for securities regulators, namely:

- the geographical diversification of the intermediaries whose activities they regulate;
- the increasing volume of cross-border investment; and
- the development of transnational markets, which are more difficult to supervise.

The problems that integrated capital markets can create for regulators are well illustrated by the last of these implications. As a result of companies seeking multiple listings on different national exchanges, it is now possible for market manipulation or insider trading to involve transactions on several different markets across several jurisdictions. Perpetrators of these types of market abuse are now able to act in other countries by using telecommunications networks or, increasingly, the Internet. These developments have made it increasingly difficult for a securities regulator in one country to draw a clear boundary around the “market” it is responsible for monitoring. Hence, as the Objectives and Principles paper notes, “in a global and integrated environment regulators must be in a position to assess the nature of cross-border conduct if they are to ensure the existence of fair, efficient and transparent markets.”

In this environment, regulators from different national jurisdictions are becoming increasingly interdependent, and there is a view that “there must be strong links between regulators and a capacity to give effect to those links. Regulators must also have confidence in one another.” The formulation of a “common set of guiding principles and shared regulatory objectives” is therefore partly a “confidence-building” measure. In this context, “confidence” primarily concerns the ability of different national regulators to gather, share and keep confidential information about market conduct. Thus the need for international...
cooperation between securities regulators is related largely to their ability to gather and share information, and the Objectives and Principles document has a different focus to that of the Basle Core Principles. Although the IOSCO paper recommends a number of prudential standards that overlap with those of the Basle Committee, its focus is elsewhere. It is not primarily concerned with the regulation of a specific set of institutions, as are the Core Principles, but with the regulation of markets and activities. In this context, the regulator's capacity for gathering and sharing information with counterparts in other jurisdictions is the most important international aspect of regulation.

In general, therefore, the difference between the Objectives and Principles and the Basle Committee's Core Principles can be summarised as follows: the Core Principles are a response to a series of banking crises which have disproportionately affected the emerging markets and which have been the cause of serious economic dislocation both domestically and internationally. By contrast, notwithstanding the perception that the East Asian crisis exemplifies a form of "contagion" risk in the securities markets, the IOSCO document should be seen as a response to the mounting difficulties encountered by regulators in exercising their monitoring and enforcement powers in increasingly internationalised markets. The development of securities markets in the emerging economies contributes only indirectly to the goal of financial stability, which is the Core Principles' main focus. Because finance in the transition economies remains highly intermediated through banking systems, the development of regulatory systems that comply with the Basle Core Principles should be their highest priority. The IOSCO Objectives and Principles are less clearly linked to fostering financial stability, and are best seen as part of a longer-term development strategy in which the growth of securities markets is encouraged to relieve some of the pressures on the banking system and thereby reduce the potential fragility of the system.

The application of international standards in the transition economies

It remains to be considered how useful these two documents are likely to be in fostering high regulatory standards in the banking and securities industries of the transition economies. The first point to stress is that both documents present their principles at a high level of generality. IO5CO's Principles are frequently qualified by phrases like "in general" or "in some jurisdictions" and hence do not represent an unequivocal statement of best practice. In this respect, the IOSCO Objectives and Principles, while more detailed than the Basle Core Principles, are also less clearly a guide to international best practice standards.

To a large extent, the comparative lack of prescription in the IOSCO document reflects the organisation's complex decision-making procedures, with their need to obtain the agreement not only of the 16-member Technical Committee (on which the main developed markets are represented) but also of the 63-member Emerging Markets Committee, which includes a number of transition countries among its membership. Because the Basle Committee is a much smaller, more cohesive group of G-10 officials, it has been able to be more prescriptive than has IOSCO.

However, even the Basle Core Principles cannot be translated into a set of specific policy recommendations without the intermediation of more detailed guidance and interpretation. A group of officials from the Basle Committee and international financial institutions is currently attempting to develop such guidance, but the fact that this step has proved necessary shows...
the difficulty in actually applying the Core Principles to specific situations. The current chairman of the Basle Committee, Bill McDonough, has compared the Core Principles to the United States Constitution, a document which has been repeatedly interpreted and reinterpreted over the centuries. Correspondingly, he argues, the Core Principles can only be applied to the circumstances of individual countries through the interpretative efforts of numerous technical experts and advisors.

Nonetheless, the Basle Core Principles have been criticised by some commentators, including some emerging market regulators, for failing to pay sufficient heed to the very different conditions which prevail in the emerging markets compared with the developed markets. These deficiencies have been discussed in particular by Morris Goldstein. In particular, he has pointed out that the 8 per cent minimum capital ratio prescribed in the Basle Capital Accord (to which the Core Principles refer) is too low in countries that experience volatile economic conditions. Moreover, the Basle Committee has yet to produce guidance on the recognition of non-performing loans, even though a failure to value assets correctly is a nonsense of any capital ratio regulators might prescribe.

These criticisms can be addressed through the preparation of detailed guidance for the application of the Core Principles to the emerging markets and transition economies. More significant, perhaps, is that the Core Principles presuppose an "infrastructure" of regulation which usually goes unremarked in the developed economies but which is often lacking from the emerging markets and transition economies. Although the Basle Committee co-opted a number of emerging market regulators into its deliberations in formulating the Core Principles, it nonetheless remained a predominately developed-world grouping. This meant that it has tended to make assumptions which reflect the conditions in the developed markets, especially concerning the availability of adequate and accurate accounting information and the existence of a legal system through which regulators can enforce their decisions.

Regulation of banks and securities markets is, in a sense, an "overlay" to a set of laws, practices, skills and expertise which are the prerequisites for effective regulation. Without these preconditions in place, the regulatory function is unlikely to be discharged either efficiently or effectively. To an extent, of course, this is simply another way of stating the well-worn concept of sequencing: for example, to develop an effective stock market, it is necessary to first put in place contract law and commercial law generally, followed by laws on securities, the stock exchange, negotiable instruments, and a law governing institutional investors. Prior to all these laws it may also be necessary to enact a constitution, setting out the legislative procedures and guaranteeing certain basic private rights. Moreover, the drafting of laws is only a preliminary to their implementation and enforcement, for which training for lawyers and judges is also required. Only when something resembling these prerequisites has been put in place does a law on the regulation of stock exchange transactions and intermediaries begin to serve any real purpose.

The IOSCO Objectives and Principles contain more explicit recognition than the Basle Core Principles of the necessity of this infrastructure of regulation. This is a reflection of the fact that IOSCO's decision-making processes have forced the securities regulators to take account of the specific conditions of the emerging markets more explicitly than the Basle Committee. Thus Annex 3 of the IOSCO Objectives and Principles details a series of elements of an appropriate legal framework for an effective securities regulatory regime. This includes company law, covering such matters as company formation, the duties of directors and officers, and the regulation of take-over bids. It also includes a body of commercial or contract law relating to private rights of contract, property rights and rules governing the transfer of those rights. Also important are insolvency laws governing the rights of security holders on winding up and the rights of clients in the event of the insolvency of an intermediary, and a law to prevent anti-competitive practices.

In addition, the IOSCO document also stresses the importance of an effective dispute resolution system, including a fair and efficient judicial system. A well-functioning judicial system matters from the point of view of regulatory enforcement actions. Without a fair and efficient court system through which to enforce regulatory decisions, regulation will either be ineffective or will lack legitimacy since it will come to be seen merely as an arbitrary exercise of power. Effective regulation importantly depends on the clarity and consistency of regulatory decision-making, and this is best guaranteed by providing for the courts to review regulatory decisions and for those affected by them to have the option of appeal to an independent and disinterested arbitrator.

This attention to the infrastructure of regulation is a distinctive feature of the IOSCO Objectives and Principles, and is implicit recognition that effective regulation cannot be divorced from the existence of an effective legal system. Just as important for both banking and securities regulation is the existence of an accounting infrastructure in parallel to the legal infrastructure, and the enactment of an efficient bankruptcy code. Accounting principles matter to securities regulators since, as discussed earlier, the disclosure of information is central to their objectives. The existence of a set of accounting principles is a precondition for
of view of the regulators and also from the point of view of the development of a credit culture. Bankruptcy and insolvency laws confer rights on the security holders on winding up. Too often transition economies do not have a bankruptcy law at all or, where such a law does exist, they often make it very difficult and time-consuming for bankers to recover the collateral behind delinquent loans. This makes the efforts to reschedule private debt more disorderly than otherwise would be the case and adds significantly to banks' credit losses. Just as important is the existence of legally enforceable netting arrangements, which will permit banks to offset liabilities against assets as they relate to the same customer. These arrangements are essential if the banking system is to develop an effective credit culture and hence the financial strength which follows from this culture.

Similarly, from the point of view of the regulators, it is vital that they should be in a position to petition for the winding up of unsound or insolvent financial institutions. The existence of a bankruptcy code is clearly an essential precondition for this. Regulators will also be more inclined to take this action if they believe that the creditors of the institution will be able to enforce their own rights at law. If ordinary creditors are left with unenforceable claims against an insolvent bank, the temptation for regulators to exercise forbearance, to delay action to avoid the consequent public clamour, will be much greater. Hence, an effective bankruptcy code also matters from the point of view of encouraging enforcement actions by the regulators.

Conclusion

Properly functioning legal and accounting systems are essential preconditions for effective regulation, and to this extent both the IOSCO Objectives and Principles and the Basel Committee's Core Principles cannot be divorced from the environment in which they are implemented. McDonough's analogy with the United States Constitution is highly pertinent, not least in drawing attention to the fact that the Founding Fathers shared many unspoken ideas and concepts in common. They were able to draw on a shared political culture, common law tradition and political discourse, which as colonists they had inherited from the home country. Without this shared basis of political agreement, it is doubtful that the US constitution would ever have proved to be as successful and long-lasting as it has turned out to be. The unspoken foundations of a constitution are as important as those that are explicitly articulated.

The importance of these factors can be seen in the various abortive attempts during the late nineteenth and early twentieth centuries to import constitutions modelled on that of the United States into the newly decolonised countries of Latin America. Without the necessary infrastructure of shared principles, beliefs and assumptions, these constitutions rapidly became a dead letter. The same point applies to the introduction of a regulatory constitution to the transition economies at the end of the twentieth century. Implementing effective regulatory regimes will require more than the enactment of a few laws and the organisation of a few training programmes. But how much more will be the real challenge for implementing international financial standards in the transition economies?
Romania has a long-standing tradition of concession. The possibility for the private sector to operate public property or public services was already recognised before the beginning of the century and progressively organised in Romania until the institution of a socialist constitution on 13 April 1948 and the subsequent passing of a series of nationalisation laws, which have progressively prohibited any involvement of private operators in the economy. It is only since the 1989 "December Revolution" and the liberalisation of the economy that the concession has been revived in Romania.

Constitutional and legal framework

Article 135 of the 1991 Constitution provides that: (i) the assets which are public property cannot be alienated to private entities; and (ii) public property assets may be "administered" (administrate) by self-managed public companies (such as Regii Autonome) or public institutions, or may be leased or granted in concession to private persons. It is generally considered that public property cannot be operated in a form other than as listed in Article 135.

Until the passing of the Concession Law, the only general rules providing for procedures for the granting of concessions and determining the contents of concession agreements were Articles 25 to 29 of Law No. 15/1990 "on the Reorganisation of State Economic Units into Regii Autonome and Commercial Companies", and Government Decision No. 1228/1990 "on the Approval of the Methodology of the Concession and Lease". These regulations were, to a large extent, inspired by the general regulations provided by the Law of 28 March 1929 "on Mining". They have now been abrogated by the Concession Law.

On 29 January 1999, a new law on concessions came into force in Romania (the "Concession Law"). The Concession Law unifies and clarifies the legal regime applicable to concessions and constitutes an important step towards the establishment of a regulatory framework better adapted to the development of concession projects in Romania.

This article summarises the main provisions of the Concession Law and examines certain issues related to their practical application.
Emergency Government Ordinance No. 30/1997 “on the Reorganisation of Regi Autonome” (as approved and amended by Law No. 207/1997) provides that the commercial companies resulting from the reorganisation of Regi Autonome will automatically be granted a concession over the public property under their administration at the time of their reorganisation.

Concerning local concessions, Law No. 69/1991 “on Local Public Administration” provides that local governments are entitled to grant concessions in relation to their assets or local public services. However, Law No. 69/1991 does not specifically define local public services and does not determine the legal regime applicable to concessions granted by local authorities, so that such regime was unclear prior to the adoption of the Concession Law. Doubts existed in particular as to whether Law No. 15/1990 and Government Decision No. 1228/1990 (which had been adopted prior to Law No. 69/1991 and did not specifically refer to concessions granted by local authorities) effectively applied to local concessions.

Finally, in addition to these general regulations governing the concession in Romania, and which have now been completed by the Concession Law, a sectoral regulation of the concession was adopted specifically for the development of motorway and railway concession projects (Ordinance No. 30/95 “on the Concession Regime for Construction and Exploitation of Land Communication Lines, Highways and Railways”, approved by Law No. 136/96). In our opinion, Ordinance No. 30/95, which the Concession Law does not expressly abrogate, remains in force after the entry into effect of the Concession Law.

The Concession Law

I. Definition and general principles governing the concession

Definition of the concession

The Concession Law unifies and clarifies the legal regime applicable to concessions by providing a general definition of the concession and setting forth general rules applicable to national as well as local concessions. Pursuant to the Concession Law, a concession is established

“(...) by a contract pursuant to which a person, designated as the ‘conceding authority’ grants another person, designated as the ‘concessionaire’, for a determined time period that may not exceed 49 years, the right and the obligation to operate a public property, a public activity or a public service at its own risk and under its own responsibility and against the payment of a concession fee.” (Article 1.2)

Object of the concession

In accordance with the Concession Law, assets which can be granted in concession are public and private property assets belonging to the State, counties (judete, cities ( orașe) or villages ( comune). The public activities and services that can be granted in concession comprise public activities and services of “national interest” or of “local interest”.

The Concession Law provides a list of such public property, public activities or public services which can be granted in concession. It does not, however, provide for a specific definition of, and distinction between, the notions of “public activity” or “public service”. The list includes property and activities that are classically the subject of concessions in other legal systems, ranging from public transportation, motorways, bridges and road tunnels and waste management to frequencies and telecommunication networks, drinking-water networks or beaches, docks and custom-free zones. The list provided by the Concession Law is only indicative, and generally, except where prohibited by a special organic law, all public property, activities or services can be granted in concession (Article 2.2, para. 1).

An important limitation to the possibility for the government or local authorities to grant concessions has been introduced by Article 2.3 of the Concession Law, which states that public property, activities or services cannot be granted in concession if there does not exist a regulatory authority “whose opinion is binding concerning the prices and tariffs applied by the concessionaire”. The provision was introduced by the Senate at the end of the legislative process and is probably meant to refer to the sectoral authorities that are intended to be established to regulate independently various fields of the Romanian economy.

In the absence of such authorities as of to date, the requirement set out in Article 2.3 of the Concession Law could hamper or at least delay the development of concession projects in Romania. In any event, the requirement does not appear appropriate with respect to public property concessions (for example, mining concessions) that do not imply the operation of a public service and a relationship with private users of such service.

With respect to local public service concessions, the requirement could further be seen as contradictory with the trend towards an effective decentralisation at the level of local authorities of the establishment of prices and tariffs of local public services, which appeared to be promoted by the draft Law “on Local Public Services” submitted to Parliament on 15 September 1998.

National and local interest concessions

The Concession Law does not provide a definition of such activities or services that are of local or national “interest”, and a specific definition thereof may not be found in other Romanian legislation. Law No. 213/1998 “on Public Property and the Legal Regime Applicable Thereto”, however, sets out certain principles for the allocation of public property assets among national and local interest services. It is expected that the Law “on Local Public Services”, when adopted, will further improve the definition of those services that shall be
the ministries and the other specialised
the county councils, local councils or
in public property for the development of the
duration of a concession shall be established
which authorities and institutions may be
allocation of responsibilities for such services
Concerning the duration of a concession,
As it appears from the complex and somewhat
it is necessary to rely on further clarification
the assets belonging to the public or private
or services of local interest.
conceeding authorities with respect to the
As it appears from the complex and somewhat
it is necessary to rely on further clarification
 Article 30 of the Concession Law sets forth
The requirement could be alleviated, however,
fee shall be provided in the terms of reference
The payment of a concession fee (reden
to an extension of the original concession beyond
the Concession Law does not set any
specified criteria limiting the parties’ right
to an extension of the original concession beyond
the Concession Law does not set any
specified criteria limiting the parties’ right
The requirement could be alleviated, however,
by mechanisms pursuant to which the
corresponding to the amount and other terms
and conditions of the concession fee. This
remains a critical component of the
the duration of a concession beyond
and other terms
This is a significant improvement to earlier
guaranteed that concessions could not be
expiring within 20 years
and did not allow for any extension thereof.
the maximum duration of a concession is
years (Article 1.2).
Article 30 of the Concession Law sets forth
the general principle pursuant to which the
duration of a concession shall be established
based on the depreciation period applicable
in respect of the concessionaire’s investments
in public property for the development of the
public activity or service conceded to it.\(^5\)

The duration of the concession shall be set out
in the concession agreement. Such duration
is subject, however, to the possibility for the
parties to a concession to extend the term of the
concession by mutual agreement for a
period of up to half of the original duration thereof.\(^6\) Except for the principle requirement
that the duration of a concession must be
established based on the depreciation period of the
assets resulting from the concessionaire’s
investment, the Concession Law does not set
any specific criteria limiting the parties’ right
to agree on an extension.

Concession fee
The payment of a concession fee (reden\(\text{ex}a\))
by the concessionaire appears as a constitutive
element of the concession. The amount and
the terms of payment of the concession fee are
determined by the relevant ministry or local
authority, including cases where the concession
is granted by a “specialised organ of the central
administration” or “a public institution of local interest”. The amount and other terms
and conditions applicable to the concession
fee shall be provided in the terms of reference
(căd de anumită) issued for the attribution of the
concession (see section II hereafter).

While the Concession Law grants a greater
freedom to the conceding authority in the
determination of the amount and other terms
and conditions of the concession fee than in
earlier legislation,\(^11\) it remains strict in its
requirement that a concession fee be stipulated
as part of any concession. This may not be
appropriate for all types of concession.
The requirement could be alleviated, however,
by mechanisms pursuant to which the
concession fee (or a part thereof) would be
returned to the concessionaire by the conceding
authority in the form of investment subsidies
for the purposes of financing specific
investments in the public assets operated by
the concessionaire (thereby limiting the impact
of the concession fee on tariffs). However,
the prohibition under Romanian law of any
subsidisation of commercial companies,
irrespective of whether these commercial
companies are operating a public service or
not and irrespective of whether the subsidy

\(^1\) Law No. 219/1998 “on the Regime of
Concessions”, adopted on 28 October 1998 at a
primary session of the Chamber of Deputies and
the Senate and promulgated on 24 November
1998 by the President of the Republic. The
“methodological norms” for the implementation of the
Concession Law were adopted by Government
Decision No. 216 on 25 March 1999.
\(^2\) In particular, the Law of 16 March 1929 “on the
Commercial Organisation and Administration of
Public Enterprises and Assets”, the Law of 26
March 1929 “on Mining” and the Law of 6 July
1924 “on Energy”. A body of case law in respect
of public property concessions as well as public
services concessions was also developed in
Romania by the courts until 1948.
\(^3\) In accordance with Article 72 of the Constitution,
an organic law is a law that may only be adopted
by the vote of a qualified majority of the Deputies
at the Chamber of Deputies and of the Senators
at the Senate, respectively.
\(^4\) As of 1 July 1999, to our knowledge, only the
National Agency for Mineral Resources and the
National Energy Agency had been established,
and the Romanian Telecommunication Agency
was in the course of being established.
\(^5\) The draft Law “on Local Public Services” is
expected to define local public services and
specify how they will be organised. It is expected
to specify what forms the concessions are to take.
It must be noted, however, that the discussion of
the draft Law “on Public Services” has since been
regularly postponed apparently, among other
reasons, due to conflicting views on the extent
to which decentralisation of the state’s functions
and regulatory powers is to be pursued in
Romania.
\(^6\) Law No. 213/1998 came into force on
22 January 1999.
\(^7\) For example, Law No. 213/1998 provides that
electricity distribution networks belong to the
public property of the state and that water,
heating and gas distribution networks belong to the
public property of municipal towns and villages irresepctively, para. 14 of Part I
and para. 4 of Part II of the Annex to the Law on
Public Property.
\(^8\) Article 27 of Law No. 15/1990 “relating to the
Reorganisation of State Economical Units into
Regi-Autonomous Commercial Companies”.
\(^9\) Romanian depreciation rules are contained in Law
No. 15/1994 “on Depreciation”.
\(^10\) It is generally agreed among practitioners that
the limitation of the duration of concessions to
49 years provided by the Concession Law does
not affect the possibility for the parties to agree
to an extension of the original concession beyond
such a duration, so that, for example, a 49-year
concession could be extended up to 24.5 years.
is for investments in public property or for covering operating expenses (which would be difficult to justify), currently forbids the implementation of any such contribution mechanism by conceding authorities.

II. The granting of a concession

The Concession Law provides in its Chapters II and III for general rules governing the procedures relating to the inception of concession projects and the granting of national and local concessions, and ensuring the transparency of the bidding process (Articles 6-27).

It is beyond the scope of this article to describe in detail the procedures set out in the Concession Law. The Concession Law appears largely to over-regulate such procedures, which would have normally been left for development in the regulations for the implementation of the Law established by the government (called “methodological norms” in Romania). We will restrict, therefore, our review to a limited number of key provisions of the Concession Law.

Inception of a concession project

A concession project may be initiated either by a “potential” conceding authority, or by any “investor” (i.e., a concession operator) interested in the concession (Article 6).

Prior to initiating a procedure for the granting of a concession, the conceding authority shall prepare a feasibility study (studiu de perspective) analysing, among others:

(i) the economic, financial, social and environmental reasons justifying the granting of a concession;

(ii) the amount of investments required for the modernisation or upgrading of the relevant public property or public activity or service;

(iii) the minimum level of the concession fee;

(iv) the procedure to be followed for the granting of the concession; and

(v) the estimated duration of the proposed concession.

If the concession project is initiated at the request of an interested operator, the relevant authority must prepare the feasibility study within 30 days of the request of the operator (or such other period of time as agreed between the authority and the operator).

Procedures for the granting of a concession

In accordance with Article 10 of the Concession Law, the concession is granted pursuant to a tender (licitatie) or as a result of direct negotiations (negociere directa).

Tender procedures

A tender for the granting of a concession may be open or closed. An open tender is a tender in which any Romanian or foreign private person (physical or corporate) may participate. The call for an open tender is published in the official gazette and in national and local newspapers. There is no obligation in the Concession Law for the public authority that is launching the tender to make any publication in the international press.

A closed tender is a tender in which only a limited number of pre-qualified Romanian or foreign tenderers may participate. The pre-qualification of tenderers in a closed tender shall be based on criteria established by the conceding authority in advance. As in the case of an open tender, the invitation setting forth the criteria to qualify for participation in the closed tender must be published in the official gazette and in national and local newspapers.

Terms of reference of the concession

The tender procedure, whether open or closed, shall be based on terms of reference prepared by the conceding authority. In accordance with Article 12, such terms of reference must set out:

- the terms and conditions applicable to the operation of the concession;
- the investments to be carried out by the concessionaire;
- the "financial and insurance clause" of the concession;
- the "legal regime of the assets that will be used by the concessionaire" (in particular the regime applicable to the relevant public domain assets); and
- environmental protection obligations.

The matters listed above constitute mandatory items which must be determined by the conceding authority at the outset of the tender procedure. The methodological norms for the implementation of the Concession Law, however, do not expand on the precise scope and contents thereof, leaving unclear what exactly shall be understood under terms like “financial and insurance clauses” of the concession (probably the tenders propose tariff structure for the concession and amounts for the insurance policies relating to the public property assets), and generally, what is the level of detail required in the determination of such matters in the terms of reference for the concession.

Direct negotiations

It is only in limited circumstances that a conceding authority may resort to direct negotiations with a potential concessionaire, since a concession may be granted through direct negotiations only in those cases where a tender procedure has not allowed the selection of a concessionaire (Article 26). In such a case, the terms and conditions of the concession granted through direct negotiations may not be less favourable than those of the best offer received in the unsuccessful tender procedure (Article 194).

This latter requirement, while attempting to set a minimum protective standard for conceding authorities in their “direct negotiations” with operators may, however, be impractical. In particular, given the multi-criteria tender evaluation method promoted by the Concession Law, it is likely that the determination whether the terms and conditions of a concession granted following direct negotiations are more or less favourable than those of the best (but rejected) tender in a failed tender procedure will be most difficult and open to criticism and claims.
III. The concession contract

The Concession Law sets out in its Chapter IV a certain number of rules governing the contents of the concession contract between a concessionaire and a conceding authority.10

Mandatory and contractual provisions

The Concession Law makes a distinction between the mandatory provisions of the concession contract also designated in the Concession Law as the “regulatory part” at Article 31.11, deriving from the terms of reference of the concession, and those “contractual” provisions that are agreed between the conceding authority and the concessionaire in addition to, and consistent with, the mandatory provisions (the regulatory part) of the contract (Article 28).13

The conceding authority may unilaterally amend the regulatory part of the concession contract at any time, where “exceptional circumstances relating to the national or local interest (...)” so justify (Article 31). Such a unilateral amendment of the concession contract is subject to prior notification to the concessionaire. The concessionaire shall be entitled to receive promptly “adequate and actual” compensation from the conceding authority in respect of any damage incurred as a result of such a unilateral amendment of the regulatory provisions of the contract. The concessionaire may, however, invoke the unilateral amendment to the terms of the concession to suspend performance of its obligations or seek termination thereof.14

The Concession Law does not make a clear distinction between mandatory and “contractual” provisions of a concession contract, and these notions remain effectively untested under Romanian law. In practice, and in order to limit the risk of unilateral amendments to a concession contract by a conceding authority, it is recommended to attempt to specify clearly in the contract those provisions which are deemed to be of a “regulatory” nature and those of a “contractual” nature. Similarly, the Concession Law does not indicate a basis for the determination of the “adequate and actual” compensation to which the concessionaire is entitled, nor the manner in which such compensation may be paid to the concessionaire. In this respect, it will certainly be necessary to explore the possibility under the Concession Law to provide, in certain cases, for a compensation of the concessionaire in the form of an adjustment to the tariffs paid to it by users (and/or, where appropriate, in the form of a revision of the investment programme undertaken by the concessionaire), rather than in the form of a “one-off” indemnity payment, which may not in all cases be the most appropriate manner to restore the financial equilibrium of the concession.15

Financial equilibrium of the concession

Concession projects generally involve the establishment of a long-term relationship between the concessionaire and the conceding authority, that will develop in an often rapidly changing legal, institutional and economic environment. By specifically stating that the “contractual relationships between the conceding authority and the concessionaire are based on the principle of the financial equilibrium of the concession” (Article 32), the Concession Law specifically addresses a major issue of concern for concessionaires. Pursuant to Article 32, the financial equilibrium of the concession consists in the “realisation of a possible equality between the advantages granted to the concessionaire and the charges imposed upon it.” As a result, Article 32 continues: “(...) the concessionaire shall not be obliged to bear the increase of charges in relation to the performance of its obligations, where such increase results: (a) from an action or measure by a public authority; or (b) from Force Majeure or a Cas Fortuit.”16

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10 Article 25 of Law No. 15/1990 provided that the annual concession fee could not be less than whichever was greater between (i) the amount equal to 5 per cent of the net profit resulting from the operation of the relevant assets or service in the five years preceding the granting of the concession; and (ii) the amount that is equal to the interest that would accrue on “the estimated value of the concession” calculated by using the “base rate of the National Bank of Romania”.

11 See also Article 9 of the methodological norms.

12 If an open or closed tender does not result in the selection of a winning tender, a new tender must be organised within 45 days of the end of the first tender (Article 19). It is only upon a failure of the second tender procedure that a tender is deemed unsuccessful for the purposes of Article 26.

13 Article 28 of the Law specifically refers to the following criteria: (i) the amount of investments undertaken by the tenderer; (ii) the “price of the services”; (iii) their “cost”, (iv) environmental protection and social considerations, (v) the professional and financial track record and guarantees of the tenderer; and (vi) the terms and conditions of the implementation of the tenderer’s investment programme. An indicative model listing certain selection criteria is provided in an Annex 1 to the methodological norms for the implementation of the Concession Law.

14 They are completed by the provisions of Articles 47-72 of the methodological norms.

15 This not least because in most of the cases the conceding authority will not have sufficient funds to be able to pay an indemnity to the concessionaire.

16 A civil law concept close to the notion of force majeure.
The introduction of the concept of financial equilibrium of the concession in the Concession Law and statutory confirmation of the possibility for concessionaires to invoke the classic “change in law” and “force majeure” concepts of international concession projects certainly constitute a substantial improvement, and are likely to bring comfort to concessionaires entering concession contracts with the Romanian State or local authorities.

It remains to be seen, however, how the concepts of “action or measure” by a “public authority” will be construed in practice, and in particular, whether the term “measure” (măsură) will cover changes in laws and ordinances or will be limited to subordinated and/or discriminatory regulatory measures taken by Romanian public authorities. In this respect, while it would appear that the “public authority” referred to in Article 32 (autoritatea publică) is any Romanian public authority and not only the conceding authority, it is very uncertain that such terms could be construed broadly to cover the Parliament.

The question also arises whether the grounds for adjustment referred to in paragraphs (a) and (b) of Article 32 are limitatively listed in the Concession Law, or whether the list can be contractually expanded, for example, to cover certain material changes in macroeconomic conditions that cannot be factored in tariff formulas (circumstances of hardship or “imprévation”).

Categorisation of assets

Upon expiry or termination of the concession, for any reason, the concessionaire shall return and hand over to the conceding authority the public property granted in concession, together with all new facilities, equipment and other improvements accrued as public property resulting from investments made by the concessionaire during the concession period (Article 29).

In this respect, inspired by a classic categorisation of French concession law, the Concession Law requires that the concession contract clearly identify and distinguish among:

- public and private property assets granted in concession and those resulting from the investments made by the concessionaire during the concession period in accordance with the investment plan set out in the terms of reference of the concession and incorporated in the concession agreement (bunuri de return);
- those assets owned by the concessionaire and used by it in the operation of the concession, which may be purchased by the conceding authority at net book value upon termination of the concession (bunuri de preluare); and
- those assets owned by the concessionaire and used by it in the operation of the concession, other than those purchased by the conceding authority upon termination (bunuri proprii).

The implementation of concession projects has long been impaired by the lack of clear constitutional or legal definition of public/private property. Although the new Law “On Public Property” will not remove all difficulties in the identification, and the allocation among national and local public authorities of public property, it will bring certain clarification to the definition and legal regime of public property in Romania.

There will remain uncertainties, however. Therefore, in order to limit the scope for discussions and disputes, and in compliance with Article 29, it is recommended, here again, to attempt to identify as specifically as possible in the contract, based on the criteria set forth in the new Concession Law:

(i) the list of those assets belonging to the public and private property of the conceding authority granted in concession and of those investments of the concessionaire that will accrue to such public property; and
(ii) the list of those assets of the concessionaire affected by the concession that are deemed to be the concessionaire’s own assets, including those assets that may be purchased by the conceding authority upon termination of the concession and those that will remain with the concessionaire after termination.

Termination

The Concession Law provides in its Article 28(5) that the parties shall agree upon the terms and conditions of the termination of the concession contract and that they may agree on specific provisions concerning the unilateral termination or “repurchase” of the concession (by the conceding authority). The Concession Law, however, provides that a certain number of statutory grounds of termination must be included in the concession contract (Article 35).

These statutory grounds for termination are:

- the expiry of the concession contract upon its term;
- the case where the national or local interest justifies the unilateral termination of the contract, in which case the conceding authority shall be liable for the payment of a fair and preliminary compensation (depagubiri) to the concessionaire;
- the breach by the concessionaire or the conceding authority of their respective obligations under the concession contract, in which case the conceding authority or the concessionaire shall be entitled to terminate unilaterally the contract and be indemnified by the breaching party;
- the destruction of the public property granted in concession as a result of force majeure, or otherwise the “impossibility for the concessionaire to operate the relevant public property”, in which case neither the concessionaire nor the conceding authority shall be entitled to compensation.

The terms and conditions applicable to the cases of termination as set out in Article 35 are mandatory so that the parties may not limit in the concession agreement their obligations arising under Article 35. In particular, the concessionaire may not seek more favourable terms of indemnification, or limit its liability in any manner in the case of termination for its own breach. However, pursuant to Article 72 of the methodological norms for the implementation of the Concession Law, the list set out in Article 35 can be contractually expanded by agreement of the concessionaire and the conceding...
authority. The parties could stipulate, for example, that in addition to the cases provided under Article 35, the concession agreement can be terminated if certain other material project contracts related to the concession are terminated (e.g., certain financing agreements or, possibly, an off-take agreement).

It must also be noted that Article 35 does not expressly state the terms upon which the concessionaire shall be indemnified by the conceding authority in respect of the new or renewed public assets financed by it ("bunuri de retur") where the concession agreement is terminated before its term.

While it is generally accepted that the enrichment procured by the concessionaire to the public domain of the conceding authority must be compensated in any case, the Concession Law does not give any guidance as to how such compensation shall be calculated. In this respect, it remains to be seen in particular whether Romanian courts will adopt the principle that the amount of the compensation payable to the concessionaire in such a case shall be based on the net book value of the relevant public assets at the time of termination, or whether they will allow for other calculation methods such as, for example, calculations based on the amount of the financial debt of the concessionaire outstanding at the time of termination.

**Conclusion**

This overview of the Concession Law does not, obviously, address all issues raised by the structuring and implementation of a concession project in Romania today. Beyond the sometimes unclear or inconsistent terms of the Concession Law, there remain further substantial clarifications and reforms to be brought to the Romanian legal framework to allow for a smooth implementation of concession projects in Romania, including improvements to tariff regulations, tax and accounting laws and public finance rules, which are beyond the scope of this article.

Nevertheless, in the difficult political and economic context Romania is currently facing, it can only be seen as a success that the Parliament passed the Concession Law, which is crucial for the development of private participation in the much-needed rehabilitation and development of utilities and public services in Romania. Combined with the Law “on Public Property”, the Law “on Local Public Finance” and, when adopted, the Law “on Local Public Services”, the Concession Law will bring significant improvements to the reliability and consistency of the legal framework applicable to concessions and should foster the structuring and development of new concession and BOT projects in Romania.

_A civil law concept often compared to the common law concept of “frustration”. Imprévision does not require that the relevant event (generally a change in macromacroeconomic conditions) prevents the performance of its obligations by the person affected by it but that it renders such performance unduly onerous. The event shall have been unforeseeable at the time of the conclusion of the contract and be beyond the control of the parties.

That is, the debt taken on by the concessionaire for the purposes of financing investment in the development and/ or renewal of the conceding authority’s public domain.

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Restructuring and recovering debt from insolvent Russian financial institutions

In this two-part series, the legal framework available in late 1998 and early 1999 to deal with the collapse of the Russian banking sector is analysed. The first article (published in the last issue of Law in transition) focused on the tools available to creditors to attempt debt recovery and damage limitation in relation to bank debts in the “pre-bankruptcy phase”, that is, prior to the revocation by the central bank of a bank’s banking licence. The present article discusses the two major additions to the legal framework for managing bank insolvency: the Law on Insolvency of Credit Organisations (the “Bank Insolvency Law”) of March 1999, and the Law on Restructuring of Credit Organisations (the “Restructuring Law”) of July 1999.

Introduction

The enactment of the Bank Insolvency Law in March 1999, following extended political debate, provided some aid to courts in dealing with the particularities of bank bankruptcies, as did secondary regulations of the central bank which have emerged throughout 1999. At the same time, the political and administrative dilemma of the central bank and government, evidenced by the reluctance to close down large numbers of banks at once, could not be resolved by the Bank Insolvency Law. Indeed the slow pace of bank licence revocations, prerequisite to opening bankruptcy proceedings, continued after March 1999. For creditors, it was of paramount importance for the government to begin to intervene in the financial collapse by imposing a state monitored and organised process of bankruptcy. This would offer the hope of equal and transparent treatment to holders of claims against failing banks, and of curbing the process of private deal-making and asset-stripping. It could be achieved by revoking licences or, in part, by instituting temporary administrations in failed banks, with enough legitimacy to wrest control of those institutions.

On the other hand, for government authorities, numerous licence revocations would have led to the dismantling of the banking infrastructure at a time when the economy’s banking and capital investment needs remained vastly unmet, without having in place a plan for reconstructing a minimally adequate financial network. Similarly, forcing the central bank to impose temporary administrations on a large number of failed banks would have severely strained its resources and tested the authorities’ political will to challenge the powerful and independent interest groups standing behind the largest failing banks. During this period of indecision, the ad hoc restructuring that did occur was private, non-transparent and encouraged by the release of stabilisation credits from the central bank.
The Restructuring Law of July 1999 introduces a full, state-managed restructuring phase, preceding liquidation, for a limited class of banks, giving the government the opportunity to rebuild a part of the banking infrastructure in a way that may more closely conform to its policy aims. Significant powers of implementation and control over the restructuring process are granted to a new federal agency, the Agency for Restructuring of Credit Organisations (ARCO). In theory, the conflicting goals of managed liquidation, championed by creditors, and rehabilitation, supported by policymakers, are accommodated in the policy compromise represented by the Restructuring Law, though only for a limited class of banks. However, the law does not address the ongoing dilemma of how to manage fairly and with dispatch the liquidation of the majority of insolvent banks.

ARCO was transformed by the Restructuring Law from a non-banking credit organisation into a government non-commercial corporation with some bank powers. As such, it is the successor in full of the prior agency (which was established soon after the banking crisis in 1998) and will continue to implement those restructuring plans which were approved and commenced prior to enactment of the Restructuring Law, even if non-compliant with it.

Scope of application of the Restructuring Law and Bank Insolvency Law

Restructuring Law

Under Articles 2.3, 3 and 10.4 of the law, the eligibility of credit organisations for ARCO assistance is measured on three levels, namely:

1. the national or regional significance of the bank, measured by assets and/or deposits (the “size test”)
2. the degree of its inability to perform, involving both failure to pay debts and the depth of capital inadequacy (the “non-performance test”) — the ability of ARCO to help.
3. the ability of ARCO to help.

First, the institution’s banking assets must be sufficiently significant. Troubled banks are eligible for such assistance if for a six-month period they satisfy criteria based on the size of their assets (1 per cent of national banking sector assets or 20 per cent of regional banking sector assets), or their share in retail banking deposits (1 per cent of deposits nationally or 20 per cent regionally).

Second, the institution must be sufficiently non-performing. A credit organisation may be placed under ARCO management if both prongs of the non-performance test are met: (i) its capital adequacy ratio, the measure by which regulators monitor the sufficiency of its aggregate capital, does not exceed 2 per cent (the “capital adequacy criterion”), calculated in accordance with the Law on the Central Bank, and (ii) it fails to meet its obligations to creditors, or to meet mandatory payment obligations, within seven days of such obligations coming due, and such failure results from absence or insufficiency of funds on its correspondent accounts (the “payment failure criterion”).

Central bank recommendation. The central bank must recommend to ARCO that the bank be placed under management within seven days of receiving “reliable confirmation” that the size and non-performance tests are met, unless the bank is taking legislatively mandated steps to avoid bankruptcy specified in the Bank Insolvency Law. Under that law, these preventive measures include self-managed financial rehabilitation, reorganisation, or submission to temporary administration by the central bank.

ARCO must accept — in its sole discretion — to take the institution on. ARCO may refuse to place a credit organisation under management if (i) doing so would not be in accordance with ARCO’s organisational or financial capabilities, or (ii) it determines that restructuring measures would be ineffective, or (iii) the credit organisation does not meet the criteria for restructuring (set out in Article 3, as described above), or (iv) there are no grounds for restructuring the credit organisation. ARCO is granted 90 days to make this evaluation. If ARCO refuses to take restructuring measures, it must notify the central bank the following day, and the central bank must within 15 days revoke the credit organisation’s banking licence if grounds for revocation (as set forth in the Banking Law) exist.

Notably, the ground for licence revocation specified by the Banking Law, relating to payment failure, is set at the 30-day mark. Conceivably, in the unlikely event that the other grounds for licence revocation are absent, a bank that was failing to pay debts within seven days might be granted an interim period prior to revocation. Discretion on this point still lies with the central bank. Once an institution meets the first and second measures of eligibility, the central bank must direct them towards either rehabilitation at the option of ARCO, or (unless the grounds for revocation are absent) to liquidation by judicial procedure. This represents a new dimension of legislative control on the exercise of the central bank discretion and could portend increased licence revocations.

1 Law No. 40-FZ of 25 February 1999 “On Insolvency (Bankruptcy) of Credit Organisations” entered into effect on 4 March 1999, save for Article 6, 16, 25.2, which entered into effect on 1 March 1999, and Article 52, which entered into effect on 1 September 1999.
2 Law No. 144-FZ of 8 July 1999, signed into law by President Putin on 9 July 1999 and officially published and entered into force on 13 July 1999.
Bank Insolvency Law

The Bank Insolvency Law envisages two categories of measures for troubled banks, one dealing with rehabilitation measures which the banks are required to implement themselves, the other with other measures implemented by a central bank temporary administration.

Self-implemented rehabilitation. Grounds for mandating self-rehabilitation include violation of the central bank minimum ratios for capital adequacy and liquidity, a decrease in capital assets of more than 20 per cent, as well as a certain degree of payment failure. While the payment failure threshold for ARCO management is seven days, here it is set at three days in most cases, reflecting perhaps a less advanced stage of instability.

Central bank temporary administration. The central bank may (but need not) impose its own temporary administration, an independent management body, within a failing bank if any of five grounds are present. These are: violating the central bank liquidity ratio by more than 20 per cent in the prior month, a decrease in capital assets of more than 30 per cent together with violation of other central bank ratios, failure to carry out self-implemented rehabilitation, grounds permitting licence revocation, and again, a specified degree of payment failure. Here, the threshold is seven days, identical to that for ARCO management, indicating that banks qualifying for either ARCO management or central bank temporary administration must reach this level of non-performance before state intervention is feasible. These grounds show a relatively deeper degree of illiquidity and instability than those that trigger the obligation to implement rehabilitation and reorganisation on an independent basis.

The obligation to self-rehabilitate, or the power of the central bank to impose an ordinary temporary administration under the Bank Insolvency Law, can arise in relation to banks of any size or relative national and regional importance.

Limits on ARCO activity

Two factors will limit ARCO’s impact on the restructuring of the banking sector. One factor is the extent of ARCO resources and what proportion of these has already been committed. Pre-Restructuring Law commitments include rehabilitation without mandatory take-over of a handful of small and medium-sized banks, as well as a Rb 1 billion loan to Alfa Bank for the purpose of restructuring regional networks. ARCO also committed to the negotiation of rehabilitation plans for two major banks, Rossiyskiy Kredit and Promstroibank. Together these commitments approximate at least 2 billion roubles, one-fifth of the Rb 10 billion capital of the agency.

Another significant factor for estimating how broad ARCO’s impact may be relates to the capital adequacy threshold for application of the Restructuring Law. Currently, under central bank standards, the reference point for a compliant bank (without considering the other norms) is a capital adequacy ratio of 8 to 9 per cent. The capital adequacy criterion of the non-performance test for eligibility under the Restructuring Law, as we have seen above, is 2 per cent. This gap explains in large part the reason why many banks will never come under the scope of the new law, which is apparently aimed at salvaging the remains of those banks whose capital has sunk to extraordinarily low levels.

Mandatory take-over

The key to the mandatory nature of rehabilitation under the Restructuring Law is that it places shareholder control of the insolvent bank with ARCO, seizing by legislative fiat the insider control that has eluded the regulators thus far. Article 4 provides:

“...if, for purposes of this federal law, the term ‘under management of the Agency for Restructuring Credit Organisations’ shall mean the implementation of measures to restructure credit organisations in which permit the Agency to determine the decisions of the credit organisation on questions within the competence of the general assembly of its founders (participants), including on questions of its reorganisation or liquidation.”

Under Russian corporate law a vote of 75 per cent of the shareholders or participants is required to pass a vote on reorganisation or liquidation. This provision is read to mean that ARCO must take over control of 75 per cent of the shares or participatory interests in the bank. At the same time, the provision is sufficiently general to embrace control by management contract or other means.

Therefore, ARCO appears to have a choice of methods for establishing control over the insolvent bank. A Article 10 merely provides that if ARCO decides to take the bank under management, it “may” announce a decision to decrease its charter capital to the level of its capital assets, and if these are negative, it may reduce the charter capital to one rouble.

Comparison between the Bank Insolvency and Restructuring Laws

Duration

The duration of ARCO’s intervention can be as much as three to four years, preceded by the 90-day investigatory phase. By contrast, central bank temporary administration has a term of 6 months, which can be extended to 18, but only after licence revocation.

Removal of management and staff

As well as taking ownership control of a bank, ARCO has the right to remove from their duties both management and staff for a period of up to one month. Their contracts must be revoked in accordance with the provisions of the Labour Code, taking into consideration the specialised provisions of the Restructuring Law, which among other things envision termination of salary and a severance payment of...
up to 20 times the minimal monthly wage. During this period, ARCO’s activity is impeded neither by shareholders nor by management of the failing bank. In addition, ARCO may decide only to limit the powers of management. The recent order of the central bank concerning SBS Agro instructs the temporary administrator appointed to consider this question: whether to permit management, other than the chairman of the management board, to remain present in the bank.

Moratorium on payments
From the onset of ARCO management, a 12-month moratorium on the bank’s repayment of monetary indebtedness or making of mandatory payments (tax, social fund payments) is imposed. The period extends from the date of ARCO’s decision to impose management for a period of 12 months, but may be extended by ARCO for up to 6 months, or reduced by ARCO, upon public notice.

The extent of a moratorium on payments imposed within central bank temporary administration under the Bank Insolvency Law (3 months, no extension) is less than under the Restructuring Law (12 to 18 months). This limited moratorium may be imposed only if (i) the powers of management have been suspended, and (ii) the bank has failed to meet its obligations for more than seven days after coming due. That is, the temporary administration was imposed in the presence of this circumstance, and not merely as a result of the violation of various central bank ratios. Regulation No. 81-P, released by the central bank on 14 July 1999, sets out the procedure for the review of petitions for moratoria by temporary administrators.

Suspension of contract performance
ARCO may, in its discretion, refuse to permit the bank to perform contracts on the grounds established in the General Bankruptcy Law. Similarly, where management’s powers have been fully suspended under the Bank Insolvency Law, the central bank temporary administrator may also suspend performance on contracts on the grounds specified in the General Bankruptcy Law. According to Article 77 of that law, an administrator under the regime of external administration may suspend the performance of executory contracts if:
- performance of the contract by the debtor would occasion harm to the debtor by comparison with analogous contracts concluded under comparable circumstances;
- the contract is a long-term contract (with a term exceeding one year) or based upon receipt of positive results for the debtor only in the long term;
- there are other circumstances impeding the revival of the debtor’s solvency.

Invalidation of transactions

ARCO banks
The nature of ARCO’s power to invalidate certain suspect transactions entered into by an ARCO-managed bank differs from that used to invalidate transactions under the Bank Insolvency Law (in turn based upon the General Bankruptcy Law) in two respects. First, it has a retrospective reach of three years, as opposed to six months, a significant extension of the risk period for creditors. Second, the Restructuring Law’s invalidation provision targets the granting of preferential terms to the bank’s affiliated entities, rather than targeting preferential satisfaction of some creditors over others. The Restructuring Law does not include a cross-reference to these other statutes, but introduces independently two bases on which the administrator may petition a court to invalidate past contracts. He may seek invalidation:
- on any ground envisioned by civil legislation, or
- in the case of a transaction entered into with an affiliated person, if the terms of the transaction envision receipt by the affiliated person of a significant preference by comparison with analogous transactions concluded in accordance with the trade usage at that time.

While the risk period for invalidation has been lengthened for counterparties of an ARCO bank, those which are not affiliated with the bank are in a better position than under the Bank Insolvency Law and the General Bankruptcy Law.

Non-ARCO banks
In a central bank temporary administration, the power to invalidate transactions of the bank is based upon those criteria set forth in the General Bankruptcy Law (Article 28 of the Bank Insolvency Law). These include invalidation under Articles 60, 78 and 101 of the General Bankruptcy Law. Under both laws, creditors of banks should note that certain classes of transactions may be judicially challenged by the administrator before a bankruptcy proceeding is ever initiated. This risk continues after the bank passes into a bankruptcy proceeding. It, in the view of the central bank, licence revocation is appropriate notwithstanding the conduct of financial rehabilitation measures or a six-month temporary administration.

The separate bases for invalidation, arising under the General Bankruptcy Law, are presented at consecutive stages of the proceeding.
Article 60: Observation stage
An administrator may seek invalidation of contracts entered into after the bankruptcy petition in violation of limits on management power.  

Article 78: External administration stage
An external administrator may seek invalidation:
- On bases envisioned by the civil legislation. (As in the first ground for invalidation given in the Restructuring Law, this is an invitation to review the legal enforceability of the debtor’s contracts in general, but does not introduce a new legal standard for enforceability);
- If concluded with an “interested person” and if, as a result of performance of the transaction, creditors have been or may be damaged. (While a different term is used, the concept of an “interested person” parallels the more specific “affiliated person” standard used in the Restructuring Law, in that both target a specific class of contracts. No retrospective period is given, an omission which creates a rather open-ended risk, particularly in cases where necessary corporate approvals for interested party transactions have been obtained);
- If the transaction will bring about the preferential satisfaction of claims of some creditors ahead of other creditors, and has been concluded within six months preceding the court’s acceptance of the bankruptcy petition.

Prior to enactment of the Bank Insolvency Law and the Restructuring Law, it was doubted whether an Article 78-type invalidation could reach a credit organisation, since the General Bankruptcy Law did not permit external administration for a bank. While the Bank Insolvency Law and the Restructuring Law also explicitly and implicitly, respectively, exclude court-managed external administration for a bank, they also represent different kinds of external administration controlled by the central bank or by ARCO. Consequently, the statement in Article 28 of the Bank Insolvency Law that the bases for invalidation set forth in the General Bankruptcy Law apply equally to banks, is fairly interpreted to reach Article 78.

Article 101.4: Liquidation stage
The liquidation administrator may seek to invalidate transactions executed by the debtor, in order to recover the debtor’s assets from third parties. No standard is given for the invalidation, so that we can infer that generally applicable principles of civil law would be used to determine whether a transaction should be invalidated. No retrospective period is identified, which in conjunction with the lack of a legal standard, creates troubling uncertainty. The liquidator’s power is therefore of concern, as it is so broad as to permit the liquidator to attack any transaction of the debtor, entered into at any time, if the liquidator believes a legal basis can be given for invalidating it. By the same token, it is not clear that this type of invalidation, reserved for the liquidation administrator, would be available prior to the initiation of bank liquidation proceedings.

Priority of satisfaction of claims
ARCO banks
Within the context of carrying out restructuring measures, ARCO is instructed to satisfy the claims of creditors “in the procedure and order specified by the civil legislation” (Article 14.3). Since the immediate consequence of ARCO management is a 12 to 18-month moratorium on payment of creditors’ claims arising prior to the imposition of management, it would appear that such claims cannot benefit from the priority rules set forth in the civil legislation at least for this moratorium period. When the moratorium is lifted, as long as a rehabilitation plan is still in place, this article suggests that claimants begin to be paid.

Provided ARCO does not decide to initiate liquidation as an alternative to rehabilitation, these creditors should benefit from the rules of Article 855 of the Civil Code, governing the priority of processing payment orders by credit organisations when funds on an account (in this case...
the correspondent account of the credit organisation) are insufficient to satisfy them all. By contrast, should ARCO determine that liquidation is the only possibility, under Article 22 of the Restructuring Law, it would petition the central bank for revocation of the licence, and if it is revoked, petition the court for a ruling of insolvency under the General Bankruptcy Law. Under the General Bankruptcy Law, Article 106, remaining assets of the debtor are distributed in accordance with Article 64 of the Civil Code.

Non-ARCO banks

By contrast, the Bank Insolvency Law contemplates the priority satisfaction of claims only in the context of a liquidation proceeding. Article 49 of the Bank Insolvency Law amends the order of satisfaction of claims in liquidation for a bank, reflecting the 1996 amendment to Article 64.3 of the Civil Code, placing bank depositors in first place. By operation of Bank Insolvency Law Article 51, the liquidation must occur under the provisions of the General Bankruptcy Law (Articles 106, 110), accommodating this addition.

The main difference between pre-liquidation and post-liquidation priorities in the Civil Code is that prior to a determination of and post-liquidation priorities in the Civil Code.

Rehabilitation plan

ARCO banks

ARCO must present a rehabilitation plan which can include various options, but must envision completion within three years. With central bank consent, this period can be extended by 12 months. Among the powers in ARCO’s arsenal are (i) replacing management and staff, (ii) seeking the invalidation of past transactions, (iii) sale of assets by public auction for most assets, or private sale for selected assets, (iv) sale of the bank as an enterprise, (v) transfer of assets to a new bank which is granted very lenient conditions for establishment, and (vi) sale of ARCO shares in the bank.

The only requirements imposed on every rehabilitation plan are that it must propose (i) measures for the restructuring of the liabilities of the bank, (ii) measures permitting the bank over time to accumulate and set aside resources for mandatory reserves, and (iii) measures permitting the bank to comply over time with prudential ratios set by the central bank.

Disposition of assets

Article 18 of the Restructuring Law sets brief guidelines for the disposition of bank assets during restructuring. Assets selected for disposition must be evaluated by an independent appraiser, which brings into play the recently enacted Law on Appraisal Activity. Most assets are to be offered in public auctions, which may be conducted by ARCO or under contract by an independent auction organisation. Those whose circulation is limited by law may only be offered in closed auctions where the participants are entities empowered by law to take title to such restricted assets, such as precious metals or “restricted securities” (e.g., shares in other banks or specific companies like RAO Gazprom). The sale of the bank itself as a business entity, or the sale of any one or more branches, divisions, subdivisions, or departments, is governed by Article 19 and the corresponding provisions of the General Bankruptcy Law (Articles 86, 87, 112.5). The Restructuring Law specifies that the sale of the bank or any of its divisions in this context shall occur without the participation of either the creditors’ meeting or committee (the term used in the General Bankruptcy Law) of the creditors’ union (the term used in the Restructuring Law). Therefore, the General Bankruptcy Law obligation to seek approval of the creditors for the terms of a tender or, by implication, for inclusion of the sale in the rehabilitation plan, would apparently not apply to ARCO. This power is another example of the broad discretion granted to ARCO, particularly in the first 12 months of restructuring.

Restructuring liabilities and amicable settlement

Since invalidating transactions and disposing of assets can only go so far in rehabilitating a bank, and indeed in reducing its burden of liabilities, one of the most critical aspects of the rehabilitation process is ARCO’s power to seek settlement with creditors. ARCO’s ability to release a bank into liquidation by asking the central bank to revoke its licence provides ARCO with great leverage to extract settlements from creditors.

ARCO is given one month, from the commencement of its management, to submit to the creditors a proposal for the restructuring of liabilities, and the creditors are then given 45 days to respond. Failure to agree results in the creditors receiving the liquidation value of their claims over the anticipated liquidation period. A plan for
Restructuring (discounting, converting, writing off, or otherwise repackaging) liabilities will be evaluated by creditors by comparing the size of the write-off in the plan with what they may be forced to take in liquidation.

If these time periods are observed, claimants may expect within approximately six months an indication of whether a deal with creditors to write down debt will succeed, or alternatively, whether the remaining assets will be distributed in liquidation. Since Article 5.2 of the Bank Insolvency Law prohibits a court overseeing the bankruptcy of a credit organisation from applying provisions of the General Bankruptcy Law dealing with amicable settlement (or external administration) to a credit organisation, the ARCO proposal for settlement is the only route to achieving a global reduction of debt by agreement of the creditors, outside of private negotiations.

Creditors’ rights have been altered as well. The assembly of creditors (the “creditors’ union”) includes both private and governmental claimants, whereas under the General Bankruptcy Law, the meeting of creditors automatically includes qualified private creditors, allowing the participation of governmental claimants only in specific cases. Disputes between the creditors and ARCO over the size or priority of their claims (both private and governmental) are resolved by an “organ created by the creditors’ union”, as compared to the right of qualified private creditors under the General Bankruptcy Law to appeal to a court to resolve disputes. In voting on a proposed settlement agreement, ARCO may represent both the federal government and regional governments if so appointed. It is not clear whether procedures for managing potential conflicts of interest will be promulgated.

Non-ARCO banks

A fundamental difference between the Restructuring Law and the Bank Insolvency Law is that, during the ARCO management period, the former combines the elements of an external administration and specific rehabilitation measures. The Bank Insolvency Law presents self-implemented rehabilitation and outside administration as two consecutive and independent phases. Insofar as the first stage is concerned, a bank must carry out a financial rehabilitation plan within an ad hoc period set by the central bank.

The financial rehabilitation measures that satisfy the law are: obtaining financial assistance from the shareholders, founders or third parties, restructuring assets and liabilities, changing the organisational structure of the bank, and “others carried out under the law.”

Financial assistance comprehends the receipt of loans bearing interest no higher than the central bank refinancing rate with a term of at least six months; receipt of sureties or guarantees for loans to the bank; receipt of extensions on repayment of debt; transfers to third parties of debt with creditor consent; refusal to distribute profits as dividends and application of such resources to rehabilitation; contributions to capital; forgiveness of indebtedness; and novation. Bank Insolvency Law Article 8.2 permits funds which are on deposit in a bank to be used by the creditors owning those funds to contribute to, and increase, the capital of the bank. Since this encompasses funds sourced outside the bank, as well as loans made by the bank, it is suspected that this provision is used at times by banks to distribute resources to affiliated entities which then contribute the loaned funds back to charter capital.

A financial rehabilitation plan including these methods is triggered either by mandatory request of the chairman of the bank, or by direct intervention of the central bank. Detailed regulations on the implementation conduct of measures for the prevention of bankruptcy appeared in central bank Instruction No. 84-I of 12 July 1999. Some procedures for monitoring the degree of banks’ payment failures were promulgated as well in by Directive No. 620-u on 4 August 1999.

“Newco” banks

Article 20 of the Restructuring Law implements one of the methods favoured since 1998 by the central bank for rebuilding the banking sector: the creation of new banks from the ashes of the old. ARCO may create “newco” banks, in which ARCO is the sole founder, in the context of rehabilitation. The assets and liabilities of the restructuring bank may be transferred to the new bank, and although compensation paid for the assets must be applied to the satisfaction of creditors’ claims, and the value of the assets must be established by independent appraisal, these provisions do not specify payment. Debts can be transferred “in accordance with the requirements of civil law” thus implying the consent of the creditors. The new bank must have charter capital satisfying the minimum capital for a non-banking credit organisation, which as of 1 July is set at €100,000 (except for subsidiaries of foreign banks). Moreover, the Restructuring Law and the contemporaneous amendment of Article 11 of the Banking Law permit ARCO to make up the capital with borrowed funds, which is ordinarily prohibited for banks. An element of external control applies insofar as the central bank may refuse to issue the banking license if it believes the proposed chairman or chief accountant does not conform to the criteria of the Banking Law. The newco banks are exempt from various requirements in the Banking Law, and are to be regulated by instructions yet to be issued by the central bank.

Recent developments in restructuring liabilities

Conversion of debt to equity. This method of reducing liabilities has been strongly recommended by the central bank, first in its outline for restructuring the banking system,
then in the April address to the Association of Russian Banks, and lastly in central bank regulations that appeared in late March. The instruction specifies that a joint-stock credit organisation may, with the consent of its creditors, exchange all or a portion of its obligations for bonds convertible into shares of that credit organisation (Article 1). Bonds (and shares upon conversion) must be issued in accordance with the requirements of Instruction No. 8 dated 17 September 1996, on Rules for the Issue and Registration of Securities by Credit Organisations on RF Territory. The bonds must be denominated in roubles, and prior to issue, the credit organisation must have in its charter sufficient authorised but unissued shares to cover the possibility of conversion. It should be noted that bond issuance is limited by Article 33 of the Law on Joint-Stock Companies to the amount of a joint-stock company’s charter capital.

Foreign creditors, even if they wish to take equity in exchange for their debt claims, face a quota on bank investment. Limits on foreign shareholdings in Russian banks are established both for the banking sector as a whole, by means of a quota, and for individual banks, by means of transfer restrictions. The current quota of 12 per cent was reportedly filled to the 5 to 6 per cent level in early 1999, although several foreign-owned banks had announced capital increases which would absorb much of the remainder. In March the central bank suggested that the quota on foreign bank capital be lifted from 12 per cent to between 20 and 25 per cent. But the Banking Law has not been amended to accommodate this. Moreover, it still requires credit organisations or holders of bank shares to obtain the prior consent of the central bank to any increase of capital drawn from foreign assets, or to any alienation of shares to or for the benefit of non-residents.

Contribution of restructured treasury bills to bank capital. A method for restructuring the liabilities of troubled banks which may be of interest to foreign creditors appeared in June 1999, and could form part of a rehabilitation plan either under the Restructuring Law or the Bank Insolvency Law. The central bank Decree No. 571-u, appearing 8 June 1999, now permits investors in credit organisations to pay for equity with restructured government treasury bonds.

Path to liquidation

Whether or not a bank has benefited from an ARCO rehabilitation plan, if efforts to restructure fail, liquidation occurs following revocation of the banking licence.

ARCO banks

ARCO may direct a bank into liquidation at two stages. First, if upon conclusion of the 90-day investigatory phase, ARCO decides not to take a bank under management, the central bank must revoke the licence within 15 days (if grounds for revocation are present), triggering the Bank Insolvency Law’s provisions on the opening of insolvency proceedings. Second, ARCO may at any time during an ARCO management decide to liquidate the bank. If the central bank then decides to revoke the licence, it must post the bank as undergoing liquidation, and ARCO must bear the responsibility of acting as liquidator. This would appear to encompass circumstances where creditors can be satisfied with existing assets of the bank but ARCO believes that the bank cannot continue to operate. Should ARCO determine that liabilities exceed assets, ARCO is responsible for submitting a petition in bankruptcy to the arbitrazh court under Chapter X of the General Bankruptcy Law, envisioning accelerated liquidation. The court is required by law to appoint ARCO as the liquidation administrator. In this way, the ARCO bank is barred from the lengthier procedure under the General Bankruptcy Law, which would normally involve an observation period followed by liquidation, or that offered to other banks under the Bank Insolvency Law.

Non-ARCO banks

For non-ARCO banks, there is no agency outside the central bank with any power to recommend revocation of the licence. If the central bank’s resources permit the requisite analysis and in-depth attention, the central bank may revoke the licence on the grounds given in the Banking Law, but there is no guarantee of adequate resources. The Bank Insolvency Law gives creditors the right to petition the central bank to revoke a bank’s licence if indications of insolvency are potentially present, and to proceed to a bankruptcy petition if there is no response in two months. But the court will dismiss the petition if the second inquiry of the central bank, this time from the court, draws a negative answer.

Grounds for licence revocation

Grounds for revocation of a bank licence which relate in the main to insolvency, were expanded in July 1998 and are as follows:

- a determination that the licence was issued on the basis of false information;
- delay of more than one year in the commencement of banking operations following issuance of the licence;
- a determination that any periodic reporting data of the bank contained false information;
- the carrying out, on a repeated basis, of operations not envisioned in the bank’s licence.


* Instruction No. 527-U of 25 March 1999 “on the Procedure for Conversion of Obligations for which a Credit Organisation is the Debtor into Obligations in the Form of Bonds of the Credit Organisation Convertible into Its Shares”.

* Article 20 of the Banking Law and In Instruction No. 264.
Article 2.2 of the Bank Insolvency Law. 

The Bank Insolvency Law, the Restructuring Law, and the significant procedural regulations which have appeared to support them, represent a net improvement in the legislative framework for managing the systemic collapse of the Russian banking sector. 

Creditors of major banks that ultimately come under ARCO management can expect to be pressed to discount, convert, exchange and otherwise reduce their debt claims, receiving, theoretically, a better managed and more transparent process in exchange. At the same time, their rights of judicial appeal during the ARCO restructuring process have been curtailed. Creditors of banks that become subject to financial rehabilitation or central bank temporary administration continue to face the difficulties of a more diffuse and less interventionist process, although they may benefit from a shorter period prior to liquidation. The scope for intervention by the central bank outside these two laws remains broad and discretionary; the release of stabilisation credits to troubled banks, estimated at Rb 100 billion from August 1998 through March 1999, continued in the summer of 1999 following enactment of the Restructuring Law.

Comparison of the main features of these two laws demonstrates the divergence in methods for dealing with a few especially significant and deeply bankrupt banks, and the remainder. ARCO rehabilitation is proposed to be a serious long-term intervention for carving out survivors and sets reduction of liabilities as a priority. In principle, a similar commitment to enforced and equitable control of assets within other failed banks prior to liquidation would be desirable, whether within the framework of a specialised law or of existing laws that give the central bank the power to intervene. The appearance of the Restructuring Law cannot deflect attention from the need properly to implement existing laws governing most banks, or from the imperative of equitable treatment for creditors and depositors, rather than subordination of their interests to the goal of recreating the banking sector in a new image.

In practice, the uneven and in some cases unskilled implementation of these two laws, as well as of the General Bankruptcy Law, have left creditors frustrated and vulnerable to increasing losses. Claimants must be prepared to pursue those rights envisioned by the legislation aggressively and to create pressure for better application. The adoption in mid-1999 of standards for licensing and training rehabilitation and bankruptcy administrators should raise the quality of administration to some degree. Recent attempts of the federal bankruptcy agency to criminally prosecute individual administrators suspected of acting in the interest of insiders, or fraudulently motivated outsiders, should be encouraged.

The need to support proper liquidation procedures, as well as restructuring efforts, remains critical. In the end, the political consensus required to shut down insolvent banks remains elusive, and may further be impeded by preparations for the parliamentary and presidential elections of December 1999 and June 2000.

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Focus on

Corporate governance

The term corporate governance does not, as yet, have a clearly defined legal doctrine in any system of law. Rather, the term embodies a range of traditional legal and non-legal concepts, and applies them to the business enterprise. As a working definition that links the following articles, governance is the system by which an organisation pursues the over-riding purpose for which it was established, and avoids pursuing other purposes. The corporate nature of governance means that the process applies when an organisation adopts a corporate form. It often implies private sector enterprises but governments also establish and sometimes participate in corporate organisation.

Although different legal traditions use a variety of techniques to enable and constrain activities that are necessary for private sector enterprise, they tend to depend at a general level on the legal institutions of property and contract, supported by standards of civil liberties and disclosure of information. On a practical level, this means that the legal aspects of governance arise in a range of circumstances. These include, for example, the design and application of laws for the organisation of companies; the rules and disclosure standards of stock exchanges and securities commissions; the settlement and clearing systems for securities transfers; rules on foreign direct investment; accounting standards; and, at policy level, social security reforms, which involve the assignment of former government functions to the private sector and the separation of the beneficiaries’ interest in the activity from those with control over it (e.g., pension reform). The articles which follow are intended to encompass a wide range of perspectives on corporate governance, and to encourage a dialogue which embraces the legal and non-legal institutions of corporate governance.

The first two articles explain, on the one hand, the EBRD’s efforts in promoting good corporate governance in its countries of operations, and, on the other, the state of corporate governance in the region as measured by a legal survey conducted by the EBRD. The article from BP Amoco highlights how law influences the governance of a long-established global corporation operating in a developed market. In addition, Professor Wymeersch provides a description of the share ownership patterns and governance regulatory techniques that appear in neighbouring western Europe, which could provide models for central and eastern Europe.

The article from CalPERS demonstrates the importance of legal aspects of governance for the choice of investment by a long-term portfolio investor. Foreign direct investment far exceeds portfolio flows in the EBRD’s countries of operations, and in that context lawyers practising in Moscow describe current governance issues at the heart of any corporate investment process, namely shareholders’ rights and board organisation of joint-stock companies in the Russian Federation.

In terms of significant institutional reform, Lucasz Konopielko of the Central and East European Economic Research Center highlights how government policy and regulatory implementation can influence governance. Lastly, the Legal Transition Events section contains the OECD’s report on a recent corporate governance round table in Moscow, where dialogue has begun among government regulators, enterprises and investors in order to explore ways to enhance governance processes in Russia.
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.1

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.2

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...
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.\(^4\)

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 fulfilling 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 (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 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 to promote 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. (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.

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.

The EBRD is required to operate in accordance with sound banking principles. 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. Within these constraints, the EBRD carries out its operations in the following principal ways, in accordance with its mandate:

- providing loans to private sector enterprises and 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.

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.

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.
With regard to banking laws, survey participants were asked to answer survey questions based on the Basel Committee on Banking Supervision’s Core Principles for Effective Banking Supervision 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 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 laws. 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.

Russia: reform of law on joint stock companies

The EBRD is currently assisting Russia’s Federal Commission for the Securities Market (FSKM) 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 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

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10 The Agreement Establishing the European Bank for Reconstruction and Development, Art.1.
11 See Art.2.
12 See Art.13(b).
14 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 Council 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 Park 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 another set of broadly recognised accounting standards, 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; and

- 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.

**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.
Focus on corporate governance

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Market perceptions of corporate governance – EBRD survey results

Russia’s default last summer and the Asian financial crisis have caused investors and academics alike to focus on corporate governance and the potential impact that ineffective systems of governance may have on shareholders in markets around the world. In central and eastern Europe and the Commonwealth of Independent States (CIS), for example, investors are beginning to question decisions made by management and to demand from management greater accountability and transparency in the decision-making process.

The focus on corporate governance within firms relates in part to the separation of ownership and control within a public company. Shareholders as “owners” provide the capital for the firm while management and the board of directors control the firm with respect to investment decisions. Company law and legal rules have been described as a means of holding management accountable for its actions. Similarly, company law also encourages means by which shareholders can participate in decision making with respect to the firm. Good corporate governance is meant to provide incentives for the board of directors and management to act in the interest of the company and its shareholders.

There has recently been an increasing emphasis on developing international principles of corporate governance that can be implemented globally. The Organization for Economic Co-operation and Development (OECD) recently promulgated a set of principles of corporate governance in an attempt to foster international consensus on this topic. The OECD Principles are intended to assist member and non-member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the development of good corporate governance. (For more on the OECD Principles see the Legal Transition Events section of this issue.)

Outstanding the OECD’s efforts, there is no single or universal model of corporate governance. Scholars have noted that the United States, Germany and Japan all have different structures for corporate governance and offer equally useful models from which transition economies might adapt their own laws and regulations. Thus, the OECD Principles are simply a framework which sets forth basic principles.

Linking corporate governance and external finance

There is a growing recognition of a correlation between levels of external finance and the existence of legal protections for investors in different jurisdictions. Law, several experts postulate, is a growing recognition of determinant for the differing levels of external finance found in various countries.

Economists Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer and Robert Vishny have analysed how investor protections, as well as the quality of their enforcement, can have an impact on the effectiveness of financial systems. Specifically, these scholars have concluded that the nature and effectiveness of various financial systems may be linked, in part, to differences in investor protections (against expropriation by corporate insiders). In a study of 49 countries, the authors concluded that countries with poorer investor protections (measured by the character of legal rules and the quality of their enforcement) have narrower or smaller capital markets. Thus, these economists believe that there is a correlation between the legal rules protecting investors and the level of external finance that a country generates.

The studies conducted by these economists examine the substantive laws in a country, but do not measure more subjective or normative factors such as the perceptions held by investors and their legal counsel or the ability of such individuals to understand the law as enacted. They do acknowledge, however, that perceptions may have an effect on the way markets develop, noting that “[i]t is possible that some broad underlying factor, related to trust, influences the development of all institutions in a country, including capital markets.”

The EBRD legal indicator survey

The EBRD’s Office of the General Counsel (OGC) has, for several years, engaged in research which attempts to measure market perceptions of the extensiveness and effectiveness of commercial and financial laws in the Bank’s countries of operations. This research, based on surveys, has focused on the perceptions of lawyers and other
experts. By contrast, much recent economic analysis of investor protections has focused on a reading and scoring of substantive laws and on measuring the effectiveness of a legal system as judged by external rating agencies.

While surveys of perceptions of laws are no proxy for a study of the truth which people have in a legal system and its institutions, they do provide data about a person’s comprehension of, and views on, those laws. They may also provide a resource for understanding how law reform and legal frameworks affect external finance. As the survey results reveal, countries with sophisticated investor protections may receive poor ratings when measured against countries with more rudimentary laws, but which have had less occasion to put them to the test. In other words, a country with fewer rules governing investor protection may be perceived as having a more effective legal environment than a country with more legal protections but where there may be clear evidence of enforcement problems.

For the past three years, one segment of the OGC’s commercial law survey has focused on company law and corporate governance. The results of this survey, analysed in this article, provide an indicator of how legal practitioners and other experts perceive corporate governance in the region with respect to (i) the role shareholders have in exercising control within joint-stock companies and (ii) the legal rules which govern or influence management behaviour within joint-stock companies.

The questions in the survey centre on certain aspects of corporate governance — specifically the rights of shareholders (including minority shareholders) and the responsibilities of directors for management of the company. The survey questions are based in large part on the EBRD’s own corporate governance guidelines, Sound Business Standards and Corporate Practices, published in September 1997, as well on the OGC’s assessment of good corporate governance practices. We have also analysed answers to questions which focus on the perceived effectiveness of the legal system in general from an investor’s perspective. The results presented below are not based on a survey tailored specifically to corporate governance. For example, questions concerning capital markets (included in a separate OGC survey on financial markets) have not been analysed.

Some of the specific topics which the OGC survey addressed include:

- the formation of a joint stock company (time and expense);
- the protections and rights of shareholders;
- director and management accountability (legislative duties and liabilities);
- the role of accountants and auditors; and
- the effectiveness of company law.

Much of the material that forms the basis of this article is not readily verifiable and reflects the subjective assessment of survey respondents. Similarly, the information and views provided by respondents were not always consistent. Where there were large discrepancies among respondents, recourse to the EBRD’s in-house knowledge of the conditions in that country was used to arbitrate. Accordingly, while the purpose of the survey was to reflect the perception of lawyers concerning company law in the region, care must be taken in reading and interpreting the results.

**General trends**

**Implementation problems appear as laws get used**

The main challenge identified by the survey is the pressing need to improve the enforcement and implementation of company laws. Many of the laws in the region provide a sound theoretical basis for good corporate governance. However, as courts, management and shareholders put these models to the test in each jurisdiction, the perceptions of outside investors and lawyers may be less positive than perceptions of less mature laws which have not been tested regularly. In 1999, economic downturn has led to a greater number of shareholders in Russia, Hungary and other jurisdictions to challenge the actions of company management and boards of directors. The Russian crisis, therefore, may have created a climate where company law and governance are being put to the test and evaluated. Shareholder activism provides an impetus for evaluating laws that may previously have remained dormant.

Based on our review of the survey data, respondents indicated that areas needing further refinement and reform included:

- the protection of shareholder rights through the use of the proxy system for annual meetings;
- the creation of more transparent annual meetings at which a shareholder can exercise voting power;
- the creation of cleaner and more specific standards for management liability and accountability;
- the implementation of shareholder rights through co-operation with management and court enforcement; and
- the operation of share registries.

**Newly enacted laws create positive perceptions**

As discussed below, countries with recently enacted laws tend to score higher in the year...
following the legislative changes. Kazakhstan enacted a law in July 1998 that replicates many provisions of the Delaware Corporations Law. The Kazakh law is comprehensive and with considerable protections for minority shareholders. The enactment of this new legislation has given Kazakhstan a higher overall score for 1999 as compared with significantly lower scores in 1997 and 1998. Additionally, Kazakhstan received a high score for the effectiveness component of the company law survey, which reflects respondents’ perceptions of the enforcement of Kazakh company law and general laws relating to investment.

Russia and Uzbekistan also received higher scores in 1997 after new company legislation had been enacted in 1996. Since then, however, their scores have dropped significantly. This result seems to reflect evolving perceptions of the law once it has been implemented. Legislation that appears comprehensive and robust as enacted, may be perceived as less effective and also less extensive once implemented. By contrast, countries that have seemingly comprehensive laws on their books may receive higher scores if they have fewer public companies and hence fewer occasions to test the effectiveness of the company law legislation.

That Moldova received a high score in 1998 may reflect its enactment of new legislation in 1997. In 1999, however, Moldova’s ratings dropped significantly, possibly because problems had been identified with the execution of the law.

Perceptions change over time
As mentioned above, one of the most interesting trends we identified is that respondents seem to rank countries with comprehensive company laws lower when the law has been in place for some time and problems may have arisen with enforcement and implementation of shareholder rights. For example, the scores of many of the countries listed as having moderate corporate governance protections, Bulgaria, Poland and Romania (in addition to Russia) have declined recently. This may reflect, to some extent, frustrations experienced by foreign investors when enforcing their rights.

Similarly, the Czech Republic has received lower scores despite having comprehensive company and securities laws - possibly because of conflicts of interests arising from high levels of indirect bank ownership of many companies, leading banks to act simultaneously as investors and creditors.

Lack of understanding of directors’ duties
The standard duty of care of corporate directors can generally be considered to consist of two duties: to monitor and to make reasonable decisions. These duties are found in a variety of laws and are not, therefore, readily ascertainable upon a reading of the joint-stock company law alone. In many jurisdictions, respondents were unable to reach a consensus on the level of responsibility (if any) held by management and directors with respect to their actions on behalf of the company. When asked if directors had any duties with respect to the company and its shareholders, respondents often provided conflicting answers for the same jurisdiction.

For example, the Bulgarian Law on Commerce does not contain any distinct provisions that elaborate the legal standard of care to be followed by directors and management of a joint-stock company. Article 240(2) provides that members of the management board and supervisory board are jointly liable for any damages they may cause. A member of the board will not be held liable if the court finds that the board member has no fault that can be linked to the damage. Board members, however, must deposit security for potential
liability in an amount specified by the general meeting of shareholders. The minimum is their salary for a three-month period.

In the Czech Republic, members of the board of directors and supervisory board are obliged to perform their duties with due care and to maintain the confidentiality of information and facts (for which disclosure to third parties would cause the corporation to suffer damage). However, Section 66 of the Czech Commercial Code states that the relationship between a corporation and its members is governed by rules of contract so it is possible that the board members’ duties will be different from those laid out in legislation. Countries with low corporate governance rankings often have no directors’ duties set forth in company legislation. Ukraine, for example, has no clearly articulated duties in its company law (which dates from 1991).

Shareholder registries are increasingly prevalent.

As a larger number of jurisdictions have functioning stock exchanges, more jurisdictions have established centralised or independent depositories that act as registration points and clearing and settlement agents for securities traded on those stock exchanges. Countries such as Bulgaria, Croatia, the Czech Republic, Estonia, Latvia, FYR Macedonia, Romania, Slovenia and Russia all have some form of securities depository and registration system for the sale and transfer of share ownership; Romania’s registration system is relatively new. Survey results reveal, however, that implementation could be improved. In some jurisdictions respondents were unclear as to whether an independent share registry existed.

Country survey results

Robust protections

Countries in this category are perceived as having comprehensive protections that are implemented in a robust manner. Courts and regulators actively enforce these protections. Legislations provides clear, broad protections for minority shareholders, establishes strict duties and liabilities for directors, and creates necessary implementing institutions such as shareholder registries. None of the countries surveyed were perceived as providing this level of robust corporate governance protections.

Reasonably comprehensive protections

Countries in this category are perceived as having laws providing minority shareholders with comprehensive protections, including the ability to elect directors by cumulative voting, to solicit proxies from other shareholders and to nominate candidates for the board of directors. The law is perceived as creating duties or liabilities for directors that are clear and enforceable. It also provides minority shareholders with adequate protections in the event of the acquisition by a third party of less than all of the shares of a widely-held joint-stock company. Respondents often indicated that shareholder registries exist and function in the jurisdictions and are often run by independent third parties. Countries in this category may need to improve the implementation of their laws in order to make the system function effectively. In a few countries perceived as having comprehensive systems, the law has not been tested in practice due to the small number of joint-stock companies or relative newness of legislative reforms.

Moderate protections

Countries in this category have basic protections for minority shareholders including pre-emptive rights, majority voting requirements, the ability to solicit proxies and to propose shareholder resolutions at the annual meeting. A realm where refinement or improvement may be needed include the elaboration of director’s duties and responsibilities, the creation of independent shareholder registries and the refinement of minority shareholder rights (for example, the introduction of cumulative voting). Implementation still lags behind the creation of substantive law. Some countries that were originally in the comprehensive category have fallen into the moderate category because poor enforcement has created negative perceptions of investor protections that appeared comprehensive on paper.

Limited protections

Countries in this category either have weak substantive company laws or laws that are perceived as weak because of problems with enforcement and implementation. Consequently, some of the countries in this category may have laws that have adequate substantive provisions but which have been rendered ineffective because they are not enforced. Several countries in this category have enacted fairly minor company law reforms in the early to mid-1990s, but are perceived as having poor laws in practice. Alternatively, these jurisdictions are
Focus on corporate governance

Perceptions of individual countries

An analysis of the 1999 results shows that of the countries surveyed, the results with respect to some of the “comprehensive” and “limited” countries correspond to a plain reading of the legislation in these jurisdictions. For example, the Hungarian joint-stock company law is considered by many commentators as a good example of a law that protects minority shareholders and encourages effective management of a company’s resources through self-enforcing governance provisions. By contrast, countries such as Belarus and Bosnia and Herzegovina have more rudimentary company laws needing substantive refinement and amendment.

Kazakhstan was perceived as having comprehensive protections in 1999, which probably reflects the adoption of a new joint-stock company law in July 1998. (Kazakhstan’s lower score in 1998 may be due to the fact that the new law became effective shortly after respondents received the 1998 questionnaire.)

The new Kazakh law has certain safeguards against conflicts of interest between management or majority shareholders and the company. For example, in an effort to promote greater transparency, the law requires that interested parties (officials of the company or shareholders with at least 5 per cent of voting shares) must be fully disclosed and approved by a majority of the disinterested members of the board. Additionally, certain major transactions must be reviewed by the shareholders.

The new Kazakh law also includes certain provisions for minority shareholder protections. Any shareholder with at least 5 per cent of a company’s voting shares may: convene an extraordinary general meeting; add items to the agenda for a general meeting; nominate candidates for the company boards; receive a list of shareholders; and have a representative on the company’s liquidation commission.

These rights did not exist under the previous law or were limited to holders of 20 per cent or more of voting shares.

One of the major drawbacks of the new law is the requirement that additional shares should only be issued pursuant to a court order. This provision allows the state, with court consent, to force a company to issue new shares to new shareholders, the proceeds of which can be used to pay a company’s back taxes and other overdue payments to the government. This provision creates the opportunity for a large dilution of shareholder interests in a company.

Hungary has received consistently high scores over the three years that OGC has conducted the company law survey. Hungary’s law appears to retain stability and robust protections both on paper and in practice. Interestingly, minority shareholders in Hungary have begun to challenge the actions of directors and management. For example, in the spring of 1999, minority shareholders at two annual meetings were able to force out several board members. Increased shareholder activism, however, has not altered the perceptions of respondents as to the effectiveness of company law. Additionally, Hungary has amended its company and securities laws in 1999, expanding some shareholder protections and narrowing others. For example, shareholders could previously call a special meeting or include an agenda item at the general meeting. Now, however, shareholders must seek court approval in order to exercise these powers. In contrast, the amendments specify that an offer to purchase 33 per cent or more of the shares of a publicly held company must be made to all shareholders of that company. This provision protects minority shareholders from the potentially overreaching behaviour of a controlling shareholder.

Slovenia also received a high overall rating from respondents. This ranking is somewhat consistent with the EU’s recent screening of Slovenia’s corporate law in the light of harmonisation with EU standards. The main deficiency noted by the Commission was a discriminatory provision in Slovene law, which states that only Slovene citizens may serve as directors of an enterprise. The Slovene government has stated that it will lift this restriction. However, Slovenia’s high rating could also reflect the fact that the law has not been truly tested due to the lack of foreign investors in the market.

For the lawyers who responded, the law may be seen as adequate to protect the interest of local investors and shareholders.

Of more interest are the countries considered to have moderate or limited corporate governance protections. Some of the countries with moderate protections may, in fact, have
Estonia and Poland). When provisions are stock companies (for example, Bulgaria, Estonia and Poland). When provisions are tested in practice as well as in court, lawyers appear to become more critical of the way the law actually works in these jurisdictions.

Poland has often been cited as a country with a good corporate governance regime. Poland is a “fast-track” candidate for EU accession and its company law has been scrutinised and evaluated as part of the accession process. Yet, surprisingly, Poland’s score dropped in 1999. Minority shareholders in Poland have become increasingly active. For example, management at Elektrim, a joint-stock company, stepped down amid protest from minority shareholders after management revealed the existence of a 1996 agreement to sell shares of a subsidiary to another company for a nominal price. However, unlike Hungary, this increased activism appears to have created a negative rather than positive perception from respondents. In early 1999, Poland published a new draft Law on Companies which includes new provisions for mergers and acquisitions and also de-mergers and splits. While the new legislation does not directly impede or alter existing shareholder rights or protections, the fact that changes have been proposed (and have been under consideration since the fall of 1998) may have altered perceptions of the existing company law.

FYR Macedonia and Moldova, both of which rank relatively high, have enacted new company legislation within the past few years and have created new systems for the registration of shares and share transfers. At the same time, both countries have often been cited for ineffective enforcement of commercial legislation. Nonetheless, they may score highly because with fewer joint-stock companies and inactive capital markets, the legislation has not been utilised or “tested” in practice.11

Countries perceived to have limited protections, such as Estonia or the Czech Republic, may have fared poorly because respondents have a pessimistic view of the way in which the law functions. The Czech and Slovak company laws, for example, are quite similar in form and substance – yet Slovakia scores higher. This may simply reflect the fact that changes have been proposed and “tested” in practice.11

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The Czech capital market is one of the oldest and most active capital markets in the EBRD’s countries of operations. The problems that have recently been highlighted may be a natural product of increased activity in this market. Czech legislation has been criticised for having loopholes or ambiguities with respect to when investors are required to act in concert to acquire majority shareholdings without triggering a requirement that they buy out minority shareholders. This is partly due to the fact that none of

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12 “Reform Assessments for Slovenia”, EBRD Transition Report 1999, p.196, noting that foreign direct investment has been discouraged by excluding foreigners from the privatization process and by the gradual introduction of capital account restrictions since 1995. Foreign direct investment inflows increased from 1.0 per cent of GDP in 1996 to 1.8 per cent in 1997, but early figures for 1998 indicate a reversal of this upward trend.
14 This view was echoed by the European Commission, which noted last summer that while the Czech Republic meets the European Union’s economic criteria for accession, it needs to improve its corporate governance. See “EU Commission Report to Confirm Czech’s Winning Reputation”, Czech News Agency, World Reporter (13 September 1999).
the acquiring shareholders have individually owned more than 50 per cent of the target company’s stock. By avoiding the 50-per cent ownership threshold, these investors have avoided having to buy out minority shareholders. Recently, the Czech SEC stated that it did not have the legal authority to rule in cases of problematic shareholder buyouts, leaving these cases to be heard by the courts.

Estonia may also be perceived as having weak protections due to its seemingly lower level of minority shareholder protections. Pre-emptive rights, for example, are not included in Estonian legislation. Nonetheless, the Estonian Stock Exchange has attempted to address some of these deficiencies by placing requirements on companies in the listing and delisting process.

Countries that received an ineffective rating have done little to reform their company laws and have fewer companies due to lack of outside investment. The exception in this category is Azerbaijan, which has seen an increase in foreign direct investment related to the oil industry. However, changes to the Azeri law and changes in practitioners’ perceptions of company law may be reflected in future surveys in the light of the enactment of a new

Azeri law on limited liability companies that came into force in April of 1999. This was before the mailing of the questionnaire, but perhaps too soon for the law’s effect to be appreciated by the respondents.

Shareholder activism

One of the survey questions asked respondents whether minority shareholders have brought lawsuits against companies or directors in order to protect or enforce their ownership rights. Responses reveal not only how shareholders feel about exercising their rights but also something about how they view the courts’ work in protecting these rights. In many instances (especially publicised cases), minority shareholders that have litigated high-profile cases in various countries in central and eastern Europe and the former Soviet Union have tended to be larger investors that have disputes with management who exercise control of an enterprise.

Respondents were given five options: never, rarely, sometimes, frequently or almost always. Those who answered “sometimes” felt that shareholders would bring litigation more than 50 per cent of the time. Those who answered “rarely” felt shareholders would go to court only about 25 per cent of the time. Results comparing responses across different geographic groupings are shown in the bar graph on the previous page.

Interestingly, the central European and Baltic respondents noted that shareholder activism (in the form of litigation) occurred more frequently than respondents in the CIS, Balkans or in Central Asia. Fifty-eight per cent of respondents in central Europe and the Baltics noted that minority shareholders were more likely than not to bring actions against a company or its directors (that is, 58 per cent felt that minority shareholders would bring lawsuits sometimes, frequently or almost always). In the Balkans or southern Europe, respondents were almost as optimistic: 45 per cent indicated that minority shareholders were more likely than not to bring lawsuits. In contrast, Central

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Asian respondents were less positive and only 33 per cent of respondents believed that minority shareholders would litigate. The figure was even lower in the CIS, with only 31 per cent of respondents answering positively. However, the survey results reveal that respondents do feel that the court system can provide an effective means of redress and protection for shareholders’ rights.

Conclusion

An interesting feature of the OGC corporate governance survey is the observation that the perception of the effectiveness of courts and judges ranges from allegations of corruption or bias towards the government or powerful commercial interests, to a general lack of understanding of newer commercial laws and complex commercial transactions. However, the survey results reveal that courts and judges rarely or never sided with shareholders, all respondents did respond that courts be noted that over one-third (38 per cent) of respondents believed that courts were more likely to side with shareholders as opposed to the company in legal disputes. As the pie chart shows, nearly half of all the respondents (47 per cent responded “sometimes”) felt that courts sided with shareholders over management more than half the time. More surprisingly, 62 per cent of all respondents believed that courts were more likely to side with shareholders in legal disputes (adding together “almost always”, “frequently” and “sometimes” responses). As the bar graph shows, these results are relatively consistent across the countries in the region – for all the regional groupings except Central Asia “sometimes” was the most frequent response. However, it should be noted that over one-third (38 per cent) of all respondents did respond that courts “rarely” or “never” sided with shareholders, revealing a significant continuing bias in favor of management and powerful commercial interests. Nonetheless, respondents who are likely to represent minority shareholders and foreign investors do feel that shareholders are more likely than not to get a fair hearing if they try to defend their rights in court.

At first glance, these results may seem counter-intuitive given the generally negative view of courts in the region. Criticism of the courts and judges ranges from allegations of entrenchment or bias towards the government or powerful commercial interests, to a general lack of understanding of newer commercial laws and complex commercial transactions.
Law and corporate governance in practice: BP Amoco p.l.c.

For a corporation such as BP Amoco, the extent to which its governance depends on law in all its forms – statute, subordinate legislation, rules of regulatory bodies, non-legal codes enforced by the authorities, judge-made law and contract – is not obvious from a cursory examination. This article attempts to throw some light on the role law plays in the governance of BP Amoco so that its significance can be better appreciated.

BP Amoco p.l.c.

BP Amoco is one of the world’s top three petroleum and petrochemical businesses on the basis of market capitalisation, with wide operational and geographic scope. It has well-established operations in Europe, North and South America, Australasia, Asia, and parts of Africa. In mid-July 1999, its market capitalisation was around US$ 180 billion.

The current composition of BP Amoco’s business is the result of some major sales, mergers and acquisitions over the past decade. It incorporates the oil businesses of a number of companies including The British Petroleum Company p.l.c., Standard Oil Company of Ohio Inc. (Sohio), Britoil p.l.c. and Amoco Corporation Inc. BP Amoco plans to purchase ARCO, another substantial oil company, by the end of 1999.

BP Amoco has approximately 315,000 registered ordinary shareholders who are entitled to one vote for each share. However, many individuals who are beneficially interested in BP Amoco shares hold their interests through various kinds of financial intermediary. A notable example is the group of 330,000 holders of American Depositary Shares, whose interest in BP Amoco shares is held on trust for them by Morgan Guarantee Trust Company of New York. Institutional shareholders, which invest in shares on behalf of their customers, hold around 90 per cent of BP Amoco’s issued shares. Individuals hold the remaining 10 per cent. No shareholder or intermediary controls more than 4 per cent of the voting rights on ordinary shares. The shares are listed primarily on the London Stock Exchange but there are also secondary listings on other major stock exchanges such as the New York Stock Exchange.

The shareholders of BP Amoco have elected a board comprising 21 directors, of whom 14 are outside directors, that is, non-executive directors. The other seven directors are employees of the company. The board appoints a chairman and deputy chairman, both of whom are non-executives. The board also appoints a chief executive officer (CEO) to head the organisation. Currently, in addition to a head office, the activity of the company is divided into about 140 business units. The number of employees at the end of 1998 was just under 100,000.

The origins of BP Amoco go back to 1901 when a single entrepreneur, William D’Arcy, acquired the right to explore for oil in Persia (as Iran was then called). D’Arcy used his own money and set up a small organisation consisting of himself, a few close associates and a few employees. The objective of this organisation was to start a business and, after eight years of difficult trials, the organisation found sufficient quantities of oil to make investment in production and transport facilities worthwhile. During the first phase, the business activities of D’Arcy’s organisation were simple and required no legal vehicle, such as a company. This history illustrates the important distinctions between an organisation (a group of people associated for a common purpose), the purpose of the organisation (in this case the purpose was business) and the legal vehicle or form used by the organisation (in this case it was contracts between D’Arcy and a range of other people).

The legal vehicle that the BP Amoco organisation has used to arrange its activities since 1909 is a company registered under the English Companies Acts. Shareholders hold shares in this English company. This
company has served as the acquiring vehicle for all the major transactions mentioned above. In making references to the company’s history, therefore, this article considers only the activities of this English company and does not take into account the activities of other companies before they merged with it or were acquired by it.

The company also owns subsidiaries in many jurisdictions around the world and generally owns all the shares in those subsidiaries. BP Amoco subsidiaries do not normally issue shares to the public. The main reason for the creation of the subsidiaries is to optimise the tax position of the business. These subsidiaries do not serve as a means of organising the activities of the company and their legally required formal processes are kept to a minimum.

Governance
In the context of an English registered company, governance may be thought of as the range of ways in which those who act on behalf of the company are required to carry out the company’s purposes, as established by the shareholders. In other words, governance covers the various ways of ensuring that directors and employees run the company’s business so as to benefit shareholders as a whole. Governance therefore covers mechanisms and systems that range from statute law to the influence of the news media.

Governance is needed both to protect shareholders and to protect other groups affected by the corporation’s activities. It protects shareholders by countering the human tendencies of directors and employees to put their own interests ahead of the shareholders’ or to favour the interests of some other party, such as the local community or a customer, at the expense of the shareholders. It protects minority shareholders against actions of powerful shareholders that prejudice the interests of the minority. Governance protects other groups affected by the company’s activities by resisting the tendency of overzealous directors and employees to enhance their or the shareholders’ interests at the expense of the legitimate interests of such groups. Shareholders are rightly concerned about governance of the corporations in which they participate but other groups may have valid concerns too.

In an English registered company, it is laid down as a matter of law that the right to control the activities of a company that is to vote on resolutions at shareholder meetings, belongs to the “members” of the company. The members need not be the suppliers of finance to a company though in listed companies they usually are. For example, the members may be customers, as in a customer co-operative, or suppliers, as in a supplier co-operative. In a company limited by shares, the members are known as shareholders and this is the form of company usually selected when members are the suppliers of finance to the company.

As a matter of English law, therefore, only the members of the company acting collectively are entitled to elect and dismiss directors. Only members can require the directors to account to them for their actions. The members (or shareholders) may therefore be said to be the holders of the control rights in an English registered company. As such, they are the only group that is legally entitled to decide what the overall objective of the company’s activities should be.

BP Amoco has been a business enterprise since its inception as an oil exploration venture in 1901, when D’Arcy invested his own wealth in the search for oil. His objective at that time was simply to obtain the best possible return on his investment. The shareholders of BP Amoco today have inherited that objective and, although the purpose of the company has varied over time as the nature of the shareholders has varied, there can be no doubt that current shareholders see their shareholder in BP Amoco as an investment in a business enterprise on which they expect a competitive return.

Given that shareholders of BP Amoco have adopted “business” as the purpose of their investment, it is important to be precise about the meaning of “business”. The precise definition of business as understood in BP Amoco is to maximise the long-term value of the shareholder’s interest in the enterprise by selling goods and services. A vital element of this definition is the long-term character of business. Unless the enterprise is to be terminated and liquidated immediately, its value will depend on its future performance. Valuation of a business enterprise on the basis that it will continue to operate requires an assessment of the future prospects of the business; hence the value of an ongoing business inevitably requires a long-term perspective.

The ways of ensuring that BP Amoco’s directors and employees carry out the purpose adopted by the shareholders operate at all levels in the company’s organisation. However, in this article it is intended to discuss governance at the first two levels in the company organisation; that is, the shareholders and the board.

Shareholder processes
The means that shareholders can use to require directors to pursue the corporate purpose can be divided into collective and individual actions.

Collective actions
One way in which BP Amoco shareholders can ensure that the board carries out the corporate purpose agreed by them is through the use of their voting rights in properly constituted collective decision-making processes. For all English companies, company law requires a properly constituted shareholder meeting for shareholders to make
a valid collective decision. The law was drafted with relatively small numbers of shareholders in mind and, for companies such as BP Amoco with large numbers of shareholders, a meeting of all or a large proportion of shareholders is physically impossible. For such companies, shareholders can only participate in collective decision-making by submitting proxy votes, that is, in effect by postal voting. With its shareholders dispersed all over the world, BP Amoco has recently amended its articles of association to ensure that only procedural matters can be voted on by the members present at a shareholder meeting; all other matters have to be decided by a formal poll of all shareholders including the proxy votes sent in by those not present.

Shareholders typically do not organise shareholder meetings themselves; directors organise such meetings on behalf of shareholders. To guard against the likelihood that directors will use their position to frustrate the ability of shareholders to make a decision that is contrary to directors’ wishes, the law has intervened to give shareholders rights to call a meeting, to circulate a proposed resolution or statement to members and to insist that various matters be put to a shareholder meeting before they can take place. Such matters include:

- alterations to the company’s constitutive documents (known as the memorandum and articles of association in English companies) which include in very broad terms a definition of the corporate purpose;
- transactions in which the directors have a conflict of interest;
- issues of shares;
- repurchases of shares;
- major acquisitions and disposals of assets.

The machinery of the shareholder-board relationship involves at some point the following kinds of collective decisions by shareholders:

a) A delegation of authority to the board by the shareholders in the articles of association.

Given shareholders’ powers to elect and dismiss directors, in reality, directors derive their powers to run the business from the shareholders. Consistent with this, BP Amoco’s articles of association contain a delegation of authority from shareholders to directors. For delegation to be most effective, there should be a clear distinction between the powers retained by the shareholders and those delegated to the board. In English companies, such a distinction usually exists. English company law and the BP Amoco articles of association state specifically the limited but important powers that shareholders retain. By implication, the rest of their powers are delegated to the board. The law allows shareholders to take back additional powers if they wish and this clear, simple division of powers has worked well in practice.

b) The general statement of the corporate purpose in the memorandum of association.

Due to the English courts’ unfortunate application of the ultra vires concept to companies, the statement of purpose in the memorandum of association has become so general that it scarcely serves its intended purpose. In this respect, one could say that English company law does not help good governance. The response of business people and investors has been to work round these difficulties. Boards informally and continually work out their own specific understanding of the shareholders’ collective view on the corporate purpose.

c) Specific directions to the board by passing a special resolution (75 per cent supermajority).

If shareholders are unhappy with the way in which the board is running the corporation, they can direct the board to do something by passing a special resolution. Specific directions by shareholders are very unusual in the experience of English companies and have not been used by BP Amoco shareholders as a way to ensure that the company is being governed properly. It is worth noting that, through their collective decision-making, shareholders can realistically deal with only a very limited number of issues. It is necessary for shareholders to delegate extensive authority and discretion to the board of directors to run the business on their behalf. English statute law recognises this by suggesting a supermajority (75 per cent) should be required in a company’s articles of association for any shareholder resolution to constitute a binding direction to the board of directors.
played an increasingly important role in the UK to meet this need. This profession has rare and has not occurred in BP Amoco.

an expert accounting profession able to depends on the availability of expert auditors:

in regular improvements in the quality of implementation of new standards has resulted development of accounting standards and the such a report as inadequate. However, this is for shareholders to pass a resolution rejecting shareholders for approval, it would be possible

auditors appointed by the shareholders.

The effective operation of the reporting system requires reports to be audited by external reporting should be done. In addition, the law

The requirement for the board to provide true and fair reports to shareholders is clearly recognised in English company law, which includes a detailed prescription of how reporting should be done. In addition, the law requires reports to be audited by external auditors appointed by the shareholders.

e) The requirement that the remuneration of directors be approved by shareholders.

In one sense, requiring shareholder approval for directors’ remuneration4 is a specific protection against the temptation for directors to set their remuneration above the market level. However, it can have greater significance for governance of the company if shareholders insist on the incorporation of incentives in directors’ remuneration that align the rewards of directors with the rewards of shareholders. In the UK, shareholders’ views on whether to incorporate incentives in the remuneration of directors are equivocal (though not so for employees). Moreover, the use of share-based incentives is contrary to the spirit of English company law. Consequently, BP Amoco does not at present include incentives in the remuneration of (non-executive) directors.

In addition, shareholders have the right under English company law to remove directors by passing an ordinary resolution (simple majority) at a shareholder meeting.

Groups of BP Amoco shareholders can enter into organised collective action outside a formally constituted shareholder meeting, for example, by meeting to discuss a specific issue. However, if shareholders at such a meeting agree to act together, then they face quasi-legal restrictions on their collective decisions and action. In the UK, if a group of shareholders that collectively owns 30 per cent or more of a company agrees to act together in some way, they are required under The City Code on Take-overs and Mergers (the “Take-over Code”) to make a cash offer for all the shares in the company. This Code has no legal status but is recognised by the courts as a system of regulation in which they will not interfere. The sanctions for breaking the Take-over Code include action by various bodies that regulate the securities markets and exclusion from the UK securities markets.

Individual actions

Another important way in which shareholders can influence the governance of BP Amoco is through their individual decisions to own BP Amoco shares or not. Shareholders and potential investors are constantly assessing whether to buy, hold or sell shares based on their own opinions of the performance of a company and its prospects. A stunning liquid market in the shares of a company, their aggregated individual judgements are reflected in the market price for the shares. At any given price, there will be those who feel that the directors are running the business well on their behalf and those who do not. Those who do not can dispose of their shares. The availability of this option naturally depends on the existence of a fair and efficient market in securities and such a market depends partly on the existence of a body of well-designed and enforced securities laws.

The daily turnover in BP Amoco’s shares is between 10 and 20 million shares, which means that it is relatively easy for small quantities of BP Amoco shares to be bought or sold without influencing the price.

If small shareholders in BP Amoco feel that the company is not being run in their interests, they have the option of selling without cost to themselves.4 However, most of BP Amoco’s shares are held by large, investment institutions which hold such large numbers that it would be impossible for them to sell without depressing the price. For them, this individual option to buy, sell or hold is of marginal value.

If the aggregated judgements of shareholders and potential investors in general is that BP Amoco is not being run in their best interests, then the price of the shares will fall relative to alternative investment opportunities. A falling share price is a problem for directors if they need access to capital; they will find it difficult to raise finance through the issue of shares. A falling share price will also lead to pressure on a company from shareholders to buy back its shares. If the share price languishes for long, other boards and managements will become interested in taking over a company’s business because they believe they can run it better. The threat of take-over is the ultimate sanction that shareholders can turn to if the board of BP Amoco is not giving them what they want. Although take-overs are costly and rarely used, the threat of a take-over is an important component within the system of ensuring that English listed companies are well governed.

An active market for take-overs and mergers requires a well-developed system of securities laws and securities market regulation. In the UK, take-overs are
Focus on corporate governance

regulated specifically by the Take-over Code which, as explained above, is not law but is enforced indirectly by the agencies that regulate the UK securities markets. Given the necessity for supermajority shareholder approval of changes to a company’s constitutive documents, it has been difficult for the boards and managements of UK-listed companies to adopt rules that would frustrate take-overs (so-called “poison pills”). In any case, there is little point in adopting such rules because the Take-over Code specifically forbids the board or management of an offeree company taking any action that would frustrate a take-over offer. BP Amoco has never proposed amendments to its articles of association that would have the effect of frustrating a take-over offer and accepts the threat of take-over as an important part of ensuring that the company is well governed.

Equality and fairness

The governance of BP Amoco depends fundamentally on the existence of general, stable agreement among shareholders on the corporate purpose and the way in which shareholder wealth is to be distributed. Without this, directors and employees would be left without a clear and reliable guide on how they are supposed to act. In a company such as BP Amoco, where currently the shares are widely dispersed and no individual shareholder controls more than 4 per cent of the votes, it is easier to obtain widespread support among shareholders for the very general corporate purpose stated above. Moreover, having one vote for each share and thus making voting proportional to the amount of investment gives shareholders an incentive to view their shareholding as an investment in a business enterprise.

In the past, this has not always been so. At one stage, the UK government held a majority of the shares in BP (as it then was) and its objectives were not simply to maximise the return on its investment. In situations like this, the dominant shareholder has the voting power to change the corporate purpose against the wishes of the minority and to alter the way in which shareholder wealth is shared out. To guard against such abuse, UK company law requires 75 per cent supermajorities for many of the fundamental collective shareholder decisions. In addition, the law does give shareholder minorities legal remedies against abuse by the majority. Similarly, the Take-over Code is based on the principle of equal treatment for all shareholders and forbids oppression of minority shareholders.

Other aspects

Overlying these specific shareholder actions, English company law establishes general duties or obligations that directors owe to shareholders. They comprise the duty to act for the benefit of the members of the company, the duty to act in good faith and the duty to exercise skill, care and diligence. These duties serve as a foundation for corporate governance but, in practice, are not an effective means for shareholders to compel directors to pursue the corporate purpose. It is very difficult for shareholders to sue directors of English companies because the circumstances in which such a suit is permitted are not clearly defined.

English company law also includes a considerable number of detailed provisions to regulate the activities of directors where they face a conflict of interest. These laws address specifically those situations where directors have obvious incentives to further their own interests or the interests of someone other than the shareholders. Such rules contribute to ensuring that directors do not enrich themselves at the shareholders’ expense. Most of them make breach of the rules a criminal offence, implying that enforcement of the rules is primarily by the state authorities, not by shareholders. However, state enforcement of these rules is not regarded as having been effective.

Board processes

At the next level down in the organisation, the governance issue that faces BP Amoco’s board is what it should do to ensure that its delegate, the CEO, carries out the purpose adopted by the shareholders.

Many aspects of the conduct and organisation of its activities are not determined by English company law. Consequently, a board has considerable discretion about its role and the way it organises its affairs. One may infer that English company law established the board as an essential link in the chain of authority that begins with the shareholders and extends throughout the organisation. In recent years, the corporate governance debate in the UK has supported this inference and resulted in various quasi-legal restrictions on the way in which boards of UK-listed companies organise their work. These restrictions have taken the form of codes of “best” practice which have been adopted by various regulatory and shareholder bodies in their rules and policies. For example, compliance with the latest code, the Combined Code on Corporate Governance (the “Combined Code”), has become a condition of being listed on the London Stock Exchange. Furthermore, the Combined Code has been the starting point for corporate governance statements by many institutional investors and their representative bodies. The codes and statements give the non-executive directors a primary role.

In 1997, in a resolution called the Board Governance Policies, the BP Amoco board recognised its obligation to shareholders to ensure BP Amoco achieves the corporate purpose. In governance terms, the BP Amoco board therefore faces two tasks. On the one hand, it has to ensure that in any of its own work it fulfils the corporate purpose and, on the other hand, that the CEO carries out the corporate purpose in the work that it delegates to him or her.

On the first task, a preliminary question is how much of the general obligation to shareholders can a board effectively carry out itself? Given the part-time nature of the BP Amoco board and its complex, collective
decision-making process, the board can realistically carry out very little of that obligation. Almost all the work has to be delegated to the CEO, who in turn delegates parts of it to other full-time employees.

The pieces of work for which the BP Amoco board has retained responsibility are, first, to understand the shareholders’ view of the corporate purpose, second, to account to shareholders for the performance of the company and, third, to find, direct, monitor and remunerate the CEO.

The main way in which the board can ensure that in its own work it achieves the shareholders’ wishes is to function effectively. To do so, a key requirement is that the board needs to be able to operate independently of the CEO and to be seen to do so. For this reason, the chairman and deputy chairman of the BP Amoco board are non-executives. It is for this reason as well that all work involved in the board-CEO relationship is delegated to committees comprised entirely of non-executive directors. In addition, the BP Amoco board has its own secretariat – the office of the Company Secretary. This office supports the board’s activities, reports to the chairman and is not part of the CEO’s executive staff. Other measures bolster the independence of BP Amoco’s non-executive directors include a limit on length of service of ten years, a requirement to resign to stand for re-election every three years and access to advice from outside sources.

The board’s second governance task is to ensure that the CEO achieves the corporate purpose with the authority delegated to him or her. Another way of saying this is that the board has to work out how to delegate effectively. A key prerequisite for effective delegation is to have a clear division between the work of the board and the work of the CEO. Assuming that both parties understand and abide by the division of work, the tasks available to the board to ensure that the CEO is carrying out the corporate purpose are direction, monitoring and remuneration. Direction covers specifying, at a level of generality that the board itself can realistically handle, the outcomes that are expected for the company if it is to achieve the corporate purpose. Direction also involves setting out the means of delivering such outcomes that are not acceptable. Monitoring compares the company’s performance and actions of the CEO (and those who work for him or her) with the board’s directions. Lastly, remuneration is perhaps the most important means available to the board. It is possible to include efficient incentives in the remuneration of the CEO. In the case of a listed company such as BP Amoco, where the company’s shares are valued by the market constantly, it is easier to incorporate into the CEO’s remuneration an element that is linked to changes in shareholders’ wealth. Such incentives, if genuinely linked to performance, are now encouraged by the UK corporate governance codes that have emerged in recent years.

Conclusion

From this survey, it can be seen that law in many forms does play an important part in the processes by which those who act for an English corporation are required to achieve the corporate purpose. For English companies, statute and common law play a greater role in the relation between shareholders and directors than in the relation between the board and the CEO. Conversely, contract is the main form of law that is found in the relation between a board and the CEO. Although law often plays no direct part in the means of governance that depend on markets, such as the financial markets, those markets would not function without a substantial legal infrastructure.

Given the enormous variety of UK organisations that use the legal vehicle of a company for the purpose of facilitating their activities, it is probably not useful for law to prescribe in great detail how the activity that takes place in such organisations should be arranged. Room must be left for the parties themselves to solve the problem of governance in the way that best suits their needs – in the words of the economist F.A. von Hayek, for order to emerge “spontaneously”. Fortunately, English company law is largely facultative and does allow considerable room for the parties involved to design the best system for their needs. However, none of these legal systems would function at all unless English society operated on the basis that everyone, no matter how wealthy or powerful, was under the law.
Focus on corporate governance

Corporate governance in western Europe: structures and comparisons

Legal techniques for regulating corporate governance practices in Europe serve goals that are linked to financial market development and share ownership patterns. The following article summarises the corporate governance implications of an investigation into ownership structure in Europe.

This article offers an overview of the areas at the heart of the corporate governance debate in western Europe. These areas include the ownership and control structure of firms, and the regulation of both relations among shareholders as well as those which link shareholders, the board and management. The strength of financial markets is a direct function of distribution of influence over corporate affairs. Two different patterns emerge. On the continent, the board is dominated by the shareholders, and therefore governance instruments are used to counterbalance this influence. Financial markets are weak and regulation attempts to avoid dilution of the interests of major shareholders. In the UK, the opposite occurs: while financial markets are stronger, shareholders are dispersed; boards are dominated by management, and governance techniques serve to limit the management's influence and strengthen the rights of the shareholders. Strikingly, the same instruments are used for totally different objectives.

Enterprise structure

Enterprise structure in western Europe presents divergent patterns. Private business firms can be contrasted with government-owned or government-operated business entities. The latter are in the process of privatisation, and therefore are confronted with important issues of corporate governance. The private firms have developed different governance patterns: these differences are linked to historical, economic and political differences, often referred to as "cultural" factors. However, in addition, differences in the ownership structure can be characterised as a determining factor that has guided the development of governance structures to what they are today. These differences should not mask the increasingly apparent fact that governance structures tend to develop towards a comparable scheme: the changing ownership structure (in this case, the increasing role of the securities markets), and therefore the firm's reliance on investors, owners of publicly traded securities, may be considered to be one of the main forces behind this drive towards de facto harmonisation.

Comparing governance structures in a selected number of European states about five years ago, we concluded that there was a vast difference in ownership structure between the continental European states and the UK. From in-depth research undertaken at the University of Ghent, based on the declaration of major holdings by shareholders who own 5 per cent or more of the shares traded on the stock exchanges, it appeared that in most of continental Europe, listed companies were dominated by one party, or by one or two parties acting in concert. One can infer that a fortiori the same situation prevails in unlisted companies. However, some significant differences appeared between the states, as illustrated in the table below.

Ownership concentration in Europe

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<th>B*</th>
<th>I</th>
<th>CH</th>
<th>SW*</th>
<th>N</th>
<th>F</th>
<th>UK*</th>
</tr>
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<tr>
<td>over 50%</td>
<td>68</td>
<td>68</td>
<td>66</td>
<td>55</td>
<td>45</td>
<td>44</td>
<td>37</td>
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<tr>
<td>25% to 50%</td>
<td>21</td>
<td>26</td>
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<td>17</td>
<td>39</td>
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<tr>
<td>under 25%</td>
<td>11</td>
<td>6</td>
<td>15</td>
<td>28</td>
<td>16</td>
<td>36</td>
<td>31</td>
<td>81</td>
</tr>
</tbody>
</table>

Germany, Italy and Belgium present a picture of a closely held corporate system: most companies are controlled by one party (over 50%) while only a handful are fully traded on the market, with no shareholder apparently controlling more than 25% of the shares. The intermediate category (25% to 50%) is the minority-controlled firms. Often de facto control will be reinforced by the existence of anti-take-over provisions. If more than one party is in a controlling position, defection by one of them may lead to a full change of control, due to the mandatory take-over rule. Although a comparable picture appears for the next three states, they can be distinguished. Switzerland presents a two-track system: large, publicly traded companies are listed alongside family-controlled firms. The same applies to the Netherlands and, to a lesser extent, to Sweden. In the last two cases, the use of protective devices (multiple voting rights, non-voting depository receipts, etc.) may give a misleading impression: although control is still firmly held in the hands of a few parties, securities are widely traded. France, on the other hand, seems to follow a somewhat more Anglo-Saxon model: this may be due to the continuous efforts of the authorities to bring additional shares to the markets.
while privatisations have taken place without retention of controlling blocks.

The pattern presented by the UK is striking: it is almost exactly the opposite of the continental European one. Although the research only related to the 500 largest UK-listed companies, it indicates that the vast majority (81%) have no controlling or other influential shareholder. With this varied landscape as a background, one can therefore expect governance mechanisms and philosophies to be different.

Corporate governance

Corporate governance deals, among other things, with the distribution of power and influence within the business structure.

In the continental European system, where most firms have a dominant shareholder, the power will be exercised by this shareholder. According to the law, the proper interest of the firm will be in the hands of the board, or by delegation, of the management. Hence, governance mechanisms tend to ensure that this overwhelming power of the major shareholder is exercised not in his exclusive interest, but also that due account is taken of the interests of the other shareholders and, according to some, even those of the firm itself. Corporate governance issues also arise in government-owned firms, including non-profit organisations.

Government-owned or government-dominated firms are confronted with conflicting objectives between the interest of the government, as keeper of the general good, and the interests of the firm. Decisions imposed on the firm in order to achieve public policy objectives of the government lead to a weakening of the firm, and in the longer term to its disappearance, often by way of “privatisation”. Other factors may result in a similar outcome: political influence both at the level of policy and of specific decisions, or with respect to the appointment of managers or employees, may not only weaken the organisation but in the longer term may also jeopardise its original mission.

In the non-profit sector, rules of good governance are sanctioned not by economic success but by weaker instruments of measurement such as a reputation standard: poor governance practices result in public scandal, loss of credibility and possibly dismissal of the board members or even dissolution of the body involved. Recent developments in the International Olympic Committee, the Football League or even the European Commission illustrate this finding.

Therefore, governance issues are common to many human organisations, and deal with ensuring that the persons appointed to achieve a certain aim do not diverge and do not serve other interests, whether their own, those of third parties, or of some (but not all) of their principals.

Ownership structure is evidently linked to the development of the securities markets. If shares of listed companies are held by a handful of shareholders, market liquidity will suffer and hence investors are less motivated to invest in those shares.

This relationship can quite easily be illustrated by comparing the market capitalisation in the same states with their overall economic importance, measured in terms of GDP. The three most significant European economies – Germany, France and Italy – account for 58% of the overall GDP. However, in terms of market capitalisation, they stand for only 31%. The opposite relationship exists in the UK: here capitalisation largely exceeds GDP (136%) while in relative terms, the UK, although standing for only 11.6% of Europe’s GDP, lists 35.5% of Europe’s overall market capitalisation. This relative imbalance has significant impact on institutional developments: states with relative underweighting of share business will have less developed markets and, as a consequence, market regulation. The UK has a very sophisticated system of market regulation, which has stood as a model for many other European regulators. The stronger markets will drive for deregulation: the UK has been the source of inspiration for much of the Investment Services Directive, while the Latin European states have sought to protect their markets by regulatory devices.5

11.6% of Europe’s GDP, lists 35.5% of Europe’s overall market capitalisation.

5 See B. Steil in The European Equity Markets, (Royal Institute of International Affairs, 1996), esp. ch. 4.
In many – even large – companies, controlling shareholders will decide fundamental issues. Investors have little or no influence on decision-making. Sometimes, they will be confronted with decisions taken by the controlling shareholder that are not necessarily in the interest of all shareholders. Hence rules have developed to streamline this threat: most significant are the rules on groups of companies, which have been formally developed in Germany but exist – although in a more flexible form – in several other EU states. In addition, there has been widespread acceptance – in the future to be imposed by EU directive – of the mandatory take-over bid, whereby the acquirer of a controlling block – typically one-third of the shares – is obliged to bid for all the remaining shares, thereby offering a withdrawal right to all shareholders.

As more companies are relying more heavily on the securities markets for financing, the role of the investor as a shareholder will receive more attention: new mechanisms for corporate suffrage are being developed, whether by introducing more efficient proxy voting systems, holding remote general meetings or by voting electronically. Disclosure standards, also in terms of internationally comparable accounting rules, will have to be updated. An integrated, comprehensive disclosure policy will have to be developed. In general, accountability to the new investor, especially the institutional investor, is one of the key themes of new governance rules.

Institutional investors

With the development in the institutional environment, is there evidence of different ownership patterns and investor behaviour? Institutional investors have been accumulating ever-larger holdings in listed companies. However, there is no evidence that domestic institutional investors have built up significant stakes in listed companies; reported holdings exceptionally exceed the 5 per cent threshold. The composition of their aggregate portfolios showed an involvement of about 20 per cent of the overall market capitalisation. These findings do not exclude the fact that in some companies institutions hold larger blocks, as appeared in some of the recent French and Italian take-overs.

The influence of institutional investors on governance mechanism has remained weak: there is some anecdotal evidence that in some cases, in the UK especially, they have been able to influence selection or dismissal of board members, auditors, mergers or acquisitions. On the continent, they have mainly addressed anti-take-over mechanisms put for approval at the general meeting. Such action has received extensive media coverage.

Board of directors

In the 1990s, the corporate governance debate in Europe has focused mainly on the effectiveness of the board of directors. Several working parties have been constituted, and several study reports or recommendations on “good practice” or “good conduct” have been published. These are known under the names of the respective chairperson: in the UK, the Cadbury report has outlined the terms of the discussion and stood as a model for similar initiatives all over the world. It was further refined in the Greenbury and Hampel reports. In France, a first Viénot report formulated rather gentle recommendations which, in a recent document, were rendered more stringent. In the Netherlands, the Peters report contained recommendations for improved functioning of the supervisory board, but later developments may lead to more fundamental change in the structure of the board. All this indicates that the issues relating to the structure and function of the board are provoking different responses in different European states, and that no single scheme is likely to emerge as predominant. This diversity can be attributed to the range of factors that influence the issue of governance. However, the central issues remain the same. These central and similar features of corporate governance systems are described below.
In most European states, it is a common feature of listed companies that they are governed by a board of directors, the members of which are elected at the general meeting of shareholders. The board is mainly in charge of deciding on policy issues, appointing and monitoring the management, including pay. It is accountable to the shareholders, who have the right to dismiss its members at will. In practice there are wide differences as to who effectively appoints the directors. In systems with controlling shareholders, directors will be appointed at the general meeting, which is de facto by the controlling shareholder. Boards that are generally subservient to the controlling shareholder will be ineffective in balancing the interests of the other shareholders against those of the controlling shareholder. Although such a company’s shares are listed and traded on public markets, it is argued that these companies are run in the interests, not of the investors as a group, but of their important shareholders. Responses to these allegations have been sought on a wide range of governance instruments: from specific disclosure, especially on intra-group dealings, to stricter rules on the laws regulating such groups. The more modern techniques of corporate governance include the appointment of independent directors or specialised committees to deal with a group’s internal conflicts of interest. Some legal systems have extended the rules on conflicts of interest to incorporate the relationships with the controlling shareholder, while others have introduced mechanisms urging the controlling shareholder to take over all the remaining shares.

In systems without controlling shareholders, the board is composed on the initiative of management or of the incumbent board members: de facto co-option and cronyism might result. Independence of judgment is pursued by appointing a significant number of independent directors, or even a majority of independent directors. However, question marks are raised with respect to their independence: often, CEOs offer one another reciprocal invitations to sit as so-called “independent” directors on their respective boards. Such reciprocities may reduce their ability to constitute an effective countervailing force.

In both cases, corporate governance recommendations have included a number of reforms that point in the same direction. The central recommendation would be that the board has to remain in full control and should take care of the interests of the company and of all its shareholders. To avoid one of the parties concerned having too strong an influence, the same techniques are used, namely, the appointment of independent directors, the organisation of internal board committees and the separation of the functions of chairman of the board and CEO.

Similar issues have arisen in companies that have formally split supervisory and management tasks. This structure is best known in the German and Dutch examples, although it is practised in several other states. The larger companies must appoint a two-tier board: one board is in charge of supervision of the company, the other of managing the company. The tenure of membership of the supervisory board is different from that of the managing board. Although the members of the latter are appointed by the supervisory board, they have considerable security in running the company as they see fit. They are better protected against dismissal than members of the supervisory board because their dismissal is not at will. The supervisory board members are effectively appointed by individual shareholders, and therefore have to ensure that their will is respected by their “sponsoring” shareholder. In these circumstances, the independence of supervisory board members becomes an issue because they are often not independent enough of one shareholder to serve the interests of all shareholders. Both in Germany and in the Netherlands some form of labour co-determination has been introduced in the supervisory board: in the German structure, half of the supervisory board members are appointed by the workforce, while in the Netherlands, members are appointed by co-option, without being representatives of the workforce.

### Decision-making control

The fundamental issue involved in the governance discussion concerns the relationship of these governing bodies to the company, the entity to which they owe their legal duties.

If one further pursues the distinction mentioned above, i.e., between companies that are controlled by one or a few parties, and those that have no controlling shareholder, a certain number of consequences follow.

In tightly controlled companies, the board’s decision-making freedom and that of the management will be restricted. A controlling shareholder may impose decisions or deny opportunities, either in its own interest or that of its group. The board will have a largely supervisory role, strictly supervising the management and authorising major decisions. These conditions for governance are likely to have a measurable impact on the management’s freedom to decide on issues such as substantial investment projects, or on the management’s own remuneration.

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Focus on corporate governance

In companies without strong shareholders, management obtains greater freedom, while the shareholder influence is formally restricted to supervision. In Germany, the power of the shareholder has been reduced by allowing management to supervision. In Germany, the power of the shareholder has been reduced by allowing management to engage in excessive projects, allowing itself for more scope for shareholder involvement (“shareholder democracy”) are all tools for strengthening the board’s supervisory function. The markets, thriving on extensive disclosure, will collectively and more explicitly monitor their conduct. Institutional investors appear recently to be eager to get a stronger hold on management, with the objective of making up for the supervisory deficit.

The priority is growth, leading to strong expansion, and, in some cases, to global business activity. Financing of major projects, including take-overs, is not restricted by the shareholders. An aggressive take-over market supports and permits this conduct. At the same time, management in these conditions has a tendency to overreach, whether by engaging in excessive projects, allowing itself compensation that exceeds its added value, or by weak supervision of the business development. Collapses occur, often in the form of a take-over bid.

Counterbalancing forces are found in these systems and also in the traditional governance instruments, mainly aimed at the reduction of the power of the management. The appointment of independent directors, the appointment of a chairperson distinct from the CEO, the organisation of committees of the board, and more scope for shareholder involvement (“shareholder democracy”) are all tools for strengthening the board’s supervisory function. The markets, thriving on extensive disclosure, will collectively and more explicitly monitor their conduct. Institutional investors appear recently to be eager to get a stronger hold on management, with the objective of making up for the supervisory deficit.

Conclusions

Governance structures in western Europe have developed against a background of certain factual developments. They are thereby the product of historical and sociological factors, and present a large variety of schemes. At a detailed level, it might appear that the ownership and control of enterprise is specific to western Europe and even particular states. However, at a general level, there are similar forces for change in both the transition economies and western Europe that make the observations and specific experiences outlined above relevant to corporate governance in transition economies. For example, the transfer of ownership from the state to the private sector, from a single-family owner or related group of shareholders to a body of dispersed shareholders (including institutional and foreign shareholders) will no doubt be a feature of both systems. The participation of employees in the future economic well-being of enterprise – whether that be by way of employee share ownership, or in the form of co-determination or information sharing – is a common general issue that may be tackled using different governance techniques. Conflicts of interest are, of course, pervasive, and the experience of western Europe in seeking to reduce these to optimal levels will continue to be important. Generally, the

Inheritance of a civilian legal tradition should make intelligible some of the regulatory tools employed and allow for development to cope with the goals of well-governed private sector enterprise. At least some of their features might interest and inspire the regulators and business communities in the transition economies."

If investments require additional financing, the controlling shareholder may fear that a share issue will dilute its holding. However, it may be that such a shareholder prefers debt financing. A certain form of financial strangulation may result, restricting the growth of the business.

The governance debate has identified a certain number of remedies: the usual instruments against conflicts of interest have been developed, but are often insufficient. Governance techniques, such as the appointment of independent directors, the organisation of specialised committees with independent directors, rules on related party transactions, and also contractual techniques leading to greater freedom for management, have been introduced in several states. Others have, for different reasons, sought to subdivide the governance structure between two boards, whereby the management obtains greater freedom, while the shareholder influence is formally restricted to supervision. In Germany, the power of the shareholder has been reduced by allowing more influence to the workforce; management initiative is favoured, except when it runs contrary to the interests of the workforce. This pitfall was avoided in the Dutch system, where the supervisory board contains no direct representatives of the workforce. Largely unrestricted by the shareholders, management obtained wide freedom, and Dutch companies have grown at a considerable pace.

In companies without strong shareholders, management dominates decision-making.

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Patient pension capital

Large pension funds held in trust for millions of future retirees currently represent a growing source of patient capital for business investment. Political, cultural and social distinctions, as well as the usual investment criteria are becoming increasingly relevant to the investor who must consider possible diversification into many different countries. The following article explains how CalPERS, the largest pension fund in the United States, goes about the serious business of determining how to diversify investments globally over the long term. This example of international investment policy development is sharply focused on some of the considerations that must be made in the transition to a more global economy.

The corporate form of business organisation is critical to continued economic development and job creation throughout the world. To be successful in an increasingly competitive economy, stay abreast of technological change and accomplish normal growth, corporations need reliable and affordable sources of capital funds. This article will discuss the increasing importance of pension funds as a source of this capital, and the way in which one US fund – the California Public Employees’ Retirement System (CalPERS) – makes decisions regarding allocation of its capital to markets around the globe.

Background

Today, US pension funds control financial assets of more than US$ 6.7 trillion, an increase of almost 45 per cent since 1994.1 Retirement systems that provide benefits to state and local government employees (known as “public pension funds”) control over one-third of these assets, or US$ 2.4 trillion.2

US investors hold over US$ 422 billion in non-US equities, with the largest 25 US pension funds holding US$ 181.1 billion of that amount.3 While general US investments in foreign markets has increased at a relatively modest 10 per cent since 1996, the US pension fund share of these foreign investments is increasing more dramatically (from 28 per cent of the total US-held foreign equity in 1996 to 42 per cent by the third quarter of 1998).4 Experts project that US pension fund assets will grow by 6 per cent over the next five years, contributing to probable continued increases in cross-border capital commitments.5

Pension fund trustees and professional administrators must stay focused on the long term. Funded retirement systems exist as multi-generational entities with liabilities that extend 40, 50 and even more years into the future. Pension fund investment strategies tend to reflect this very long-term viewpoint. For example, as measured by turnover rates,6 pension funds – and most particularly public pension funds – generally hold their equity investments significantly longer than other types of US investors.7

These data indicate the growing importance of US public funds as a reliable source of patient capital, now and into the future. As discussed below, the CalPERS Board of Administration and the System’s professional administrators are fully aware of the relationship between the long-term liabilities of the fund they administer and the importance of the capital funds they provide to a competitive global economy.

CalPERS

With assets valued at over US$ 150 billion, CalPERS is the largest pension fund in the United States.8 CalPERS has achieved double-digit returns for six of the last seven years. For the past three-year period (ending 31 May 1999), CalPERS earned 16.3 per cent on its investments; for the five-year period (also ending 31 May 1999), the fund earned 15.8 per cent.9

CalPERS’ mission is to ensure the retirement and health security of its over 1 million members.10 As a defined benefits system, CalPERS’ assets are directly tied to the benefits that must be paid to these members, and their survivors, over their lifetimes. Based on the expected ageing of the population, and the impact of this global issue on CalPERS in particular, the current US$ 150 billion in assets approximates the amount, as measured and forecast at this moment, that is needed to meet CalPERS’ future benefit liabilities.11

One of the responsibilities of the CalPERS Board of Administration is to determine how the trust fund is to be allocated for investment among various possible asset classes.12 A set allocation is the most important element of CalPERS’ investment strategy, and is never made in isolation. This critical decision must be made - and periodically revisited - with full view of the System’s future stream of liabilities, employer and employee contributions to the fund, and estimated future operating costs. The Board’s goal is to maximise returns at a prudent level of risk - an ever-changing balancing act between market volatility and long-term goals.13
CalPERS follows a strategic asset allocation policy that identifies the percentage of the System’s funds to be invested in each asset class. Policy targets are typically implemented over a period of several years on market declines and through dollar cost averaging. CalPERS’ current asset allocation mix by market value and policy target percentages is shown in Table 1.

CalPERS’ commitment to non-US markets began in 1986 with a 10 per cent allocation (to both international equities and fixed income). This commitment has steadily increased so that, as demonstrated in Table 1, 20 per cent of CalPERS’ fund is currently targeted for allocation to non-US equity markets and 4 per cent to non-US debt markets. In the Board’s view, investments outside of the US are critical to obtain both diversification and increased returns. To date, all of CalPERS’ international investments have been managed by outside firms hired by CalPERS for this purpose. These managers are selected based upon their style (e.g., passive vs. active, growth vs. value) and regions of expertise (e.g., Europe vs. Asia). Once selected, the firms are delegated discretion for the assets under their control. This discretion is limited, however, by two factors. First, in the usual fashion the managers’ compensation is directly linked to specified performance benchmarks. To the extent a particular country’s market is excluded from the benchmark index, the manager may be less inclined to invest CalPERS assets in it. Secondly, the CalPERS Board has affirmatively determined that certain countries’ markets are outside the scope of the managers’ discretion; that is, they may not make equity and/or debt investments in them. Further, the Board has also determined that certain other markets pose a sufficient degree of relatively higher risk to justify limiting the managers’ discretion to invest in them; in other words, the manager may invest in such markets, but only to an expressly limited degree.

CalPERS’ “permissible country” process

CalPERS’ Permissible Country Programme does not seek to determine the relative attractiveness of specific markets. CalPERS delegates this determination to its external asset managers. Rather, the Programme seeks to identify those markets that, in the opinion of the CalPERS Board, are “safe” enough to support institutional investment practices by a very large defined benefit public pension fund.

CalPERS retains an outside consultant to assist in the evaluative process that leads to identification of “permissible countries”. With respect specifically to equity investments, the consultant suggests that eight broad categories capture each market’s opportunity and risk factors. The relative importance of each category is weighted, and the sum of the weighted categories represents the consultant’s overall evaluation of each market/country. The Table 2 depicts all eight categories, with their weightings; the discussion below describes each factor more specifically.

Within each of these eight macro-categories is a series of micro-factors:

1. The political risk category analyses the risk to foreign investors resulting from political changes in a country that can have a negative impact on market openness, liquidity or performance. Markets with apparently stable and democratic political systems, and those committed to supporting foreign investment, are ranked high. Markets with political systems judged to be unstable are ranked lower. Each
country’s sovereign credit rating is also analysed, as a reflection of a country’s stability, and its willingness and ability to repay its debt.

2. When analysing market liquidity and volatility, the consultant seeks to measure the ability of an investor to sell assets in a country in a manner that is timely and does not adversely affect security prices. Other factors indicative of stock market return volatility are also evaluated.

3. Country development is a very broad category. First, GDP per capita is used to measure the economic strength of a country, and is a general measure of wealth. Wealthier countries tend to have better developed financial infrastructure and, generally, present less overall risk to foreign investors. GDP per capita is assigned the highest micro-factor weight within this category. Other lower weighted micro-factors are average annual GDP percentage growth; the health of the country’s banks; level of education in the labour force; labour force productivity; and population literacy rates.

4. Market regulation/legal system/investor protection is assigned the heaviest weighting because, under the current CalPERS Permissible Country Programme, it represents the key to a country’s investment climate. The micro-factors within this category seek to measure the degree to which foreign investors are legally protected in each market, through regulations and the existence of shareholder and creditors’ rights. The role of a dedicated market regulatory agency, as well as each

<table>
<thead>
<tr>
<th>Category</th>
<th>Assigned weight (%)</th>
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<tbody>
<tr>
<td>1 Political risk</td>
<td>10</td>
</tr>
<tr>
<td>2 Market liquidity/volatility</td>
<td>15</td>
</tr>
<tr>
<td>3 Country development</td>
<td>10</td>
</tr>
<tr>
<td>4 Market regulation/legal system/investor protection</td>
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</tr>
<tr>
<td>5 Investment restrictions</td>
<td>15</td>
</tr>
<tr>
<td>6 Settlement efficiency</td>
<td>15</td>
</tr>
<tr>
<td>7 Transaction costs</td>
<td>5</td>
</tr>
<tr>
<td>8 Year 2000 compliance, technological growth</td>
<td>10</td>
</tr>
</tbody>
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### Chart I
**CalPERS’ fixed income permissible country list (effective 14 June 1999)**

<table>
<thead>
<tr>
<th>Country</th>
<th>Permissible</th>
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<tbody>
<tr>
<td>Australia, Austria</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Belgium, Canada, Denmark</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Brazil</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Chile</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Czech Republic, Greece</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Egypt, Hungary, India</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Jordan, Kenya, Morocco</td>
<td>Prohibited</td>
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<tr>
<td>Netherlands, New Zealand</td>
<td>Prohibited</td>
</tr>
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<td>Norway</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Portugal, Singapore</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Spain</td>
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</tr>
<tr>
<td>Sweden</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Switzerland, United Kingdom</td>
<td>Prohibited</td>
</tr>
<tr>
<td>United States</td>
<td>Prohibited</td>
</tr>
</tbody>
</table>

* Maximum 5% indicates that the collective proportion comprising these countries may not exceed 5% of the portfolio managed.

Authorised list notwithstanding, credit ratings and liquidity considerations must meet the criteria in the manager’s investment management guidelines.

### Chart II
**CalPERS’ equity permissible country list (effective 14 June 1999)**

<table>
<thead>
<tr>
<th>Country</th>
<th>Permissible</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia, Austria</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Belgium, Canada, Denmark</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Brazil</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Chile, Czech Republic, Greece, Hong Kong (SAR), Hungary, Israel</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Malaysia, Mexico, Philippines, Peru, South Africa, Taiwan, Thailand</td>
<td>Prohibited</td>
</tr>
<tr>
<td>Turkey</td>
<td>Prohibited</td>
</tr>
</tbody>
</table>

* CalPERS instructs managers to limit exposure to group B in total to 20 per cent of the aggregate portfolio of broad non-US equity mandates that permit exposure to the emerging markets. In addition, specific countries in this category should not exceed two times their market capitalisation weight or 5 per cent of the portfolio, whichever is lower.

** Malaysia currently has capital controls in place and is not permitted for investment until these controls are lifted.

Authorised list notwithstanding, credit ratings and liquidity considerations must meet the criteria in the manager’s investment management guidelines.
country’s laws, are reviewed to assess the following equally weighted factors:

- Adequacy of financial regulation: higher scores reflect a strong agreement to the statement, “Regulation and supervision of financial institutions is adequate for financial stability”.24
- Bankruptcy/creditors’ rights: this factor seeks to measure the adequacy of creditors’ rights in each market, in the case of bankruptcy or reorganisation proceedings.25
- Shareowners’ rights: higher scores reflect stronger regulations regarding the legal rights of equity holders to protect their ownership interests (through proxy, judicial and other avenues).

5. The degree of market openness to US investment is a critical parameter of a government’s commitment to free-market policies. Countries with higher restrictions on foreign investment receive a lower score.

6. Countries with automated trading and settlement procedures, through which transactions are settled in a timely and efficient manner, receive a higher score.

7. The transaction costs factor measures the costs associated with trading and includes stamp taxes and duties, amount of dividends and income taxed, capital gains taxes and commission rates.

8. Year 2000 compliance and technological growth looks primarily at the degree to which a country’s companies are expected to suffer mission-critical systems failure,26 and then at its ability to absorb new technology.27

Using the scores derived through this process, the CalPERS Board makes three critical decisions. First, the Board identifies those countries/markets in which it is appropriate for CalPERS’ managers to exercise unlimited investment discretion. Secondly, the Board identifies those countries/markets that represent a relatively higher degree of risk for institutional investment, thereby limiting investment managers in their ability to make investments.28 Finally, the Board identifies those countries/markets that are, at the time of the list compilation, inappropriate for any CalPERS manager to invest. By default, every country not on one of the two earlier lists is considered to be in this last category. Moreover, each of these policy determinations are, of course, made effective on the date the final Permissible Country Programme ‘list’ is adopted, and subject to change as conditions in the various country markets change.29

Conclusion

CalPERS’ Permissible Country Programme probably is unique among US public pension funds. However, as US investment in non-US markets continues to expand, other large institutional investors may adopt similar programmes. When any country’s laws, regulations, political stability, business culture or market practices impose relatively greater risk on foreign investors than is the case in other available markets, it will become increasingly difficult for the more risky market to attract new capital funds. Better, more rapid communication, improved company and market transparency, and the increasingly global nature of competition for capital funds will promote more thorough analytical approaches to evaluating foreign investment opportunities. There is no longer any capital market that can exist as an island in the new sea of global competition, and no institutional investor that can afford to avoid at least considering the risk-adjusted investment opportunities that may be found in every corner of the world.30

24 As reported in "CalPERS Equity Investment – Analysis and Recommendations (April 1999)."
25 Ibid.
26 Specifically CalPERS’ equity managers must limit total exposure to this group of countries to no more than 20 per cent of the aggregate portfolio of broad US equity mandates that permit exposure to the emerging markets. In addition, investments in specific countries in this category may not exceed two times their market capitalisation weight, or 5 per cent of the portfolio, whichever is lower. Similarly, the collective proportion of CalPERS’ fixed income managers’ portfolios comprising these countries may not exceed 5 per cent of the portfolio managed.
27 Chart I includes CalPERS’ current Permissible Country List (Equity). Chart II includes the Permissible Country List (Debt).
28 As reported by JP Morgan, “January 1, 2000: Ready or Not?”. 21
29 As reported by Wilshire Associates Inc., "Focus on Corporate Governance: CalPERS’ Permissible Country Programme may be unique among US public pension funds", 20
30 The authors wish to note that the CalPERS Board is, at the time of writing this article, reassessing its Permissible Country Programmes. Thus, the process, criteria and weightings discussed herein may be changed at some time in the future.
31 Wilshire Associates Inc.
Focus on corporate governance of these is likely to develop in the future. The process of joining the EU and in particular Polish participation in monetary union.

Economic background and case for reform

After much debate, a new three-pillar pension system was implemented in Poland on 1 January 1999. Among other factors, the reform was introduced to facilitate the process of joining the EU and in particular Polish participation in monetary union.

State budgetary concerns are the main reasons for these reforms, as social security spending is viewed as a major factor contributing to budget deficits and consequently high inflation. In 1993 the budget subsidy for the social security system amounted to more than 12 per cent of budgetary spending, while in 1996 it stabilised at a level of 6 per cent. The previous pension system, based solely on pay-as-you-go (PAYG) funding, was generally regarded as unjust and obsolete. In particular, the common view was that benefits were not related to contributions. Moreover, demographic predictions indicated that this system was only sustainable for another 10 to 15 years. Accordingly, the reform of the social security system is intended to rationalise the existing system, introduce real links between contributions and benefits, and diversify sources for financing benefits.

There are also strong links between this reform and other elements of the development of the market economy. The envisaged flow of funds, which assumes that part of currently paid contributions will be capitalised, requires significant acceleration of privatisation in order to maintain budgetary deficit limits.1 Legislation on using privatisation revenues for financing the pension system reform2 establishes the legal basis for these operations. Accordingly, the acceleration of privatisation coupled with the creation of new institutions, i.e., private pension funds, are expected to play a significant role in the governance of invested public and particularly privatised firms. Although investors’ appetite to finance firms is likely to be biased toward debt over equity for some time (see below), the development of financial market discipline fuelled by debt will influence the development of corporate governance. However, the extent of such influence will depend heavily on existing regulations and emerging practices.

Reform spillovers are expected to occur in the area of capital market development. New, well-capitalised financial market institutions – open pension funds – are created, which, it is estimated, will be responsible for investing around 1 per cent of GDP per year by 2010. Even by 2000, they will receive in nominal terms the equivalent of more than US$ 500 million. Although limited by the requirements described below, a significant part of this is expected to be invested on the Warsaw Stock Exchange, which is currently capitalised at around US$ 30 billion, with an average daily turnover in 1998 of US$ 35 million.

The policy expectation associated with this new system is that it should boost market development because it will encourage new firms to use various forms of external financing partly based on pension funds investments. Pension funds will thereby become significant players in financial markets. The potential discipline of the financial markets on savings and investment behaviour lies at the heart of the corporate governance issues underlying the change in the Polish pension system. Additionally, potential benefits include those arising from the impact on the asset distribution of investment portfolios and on allocation efficiency due to institutionalisation, financial innovation and the creation of specialised intermediaries providing financial services.3

Polish pension reform and corporate governance issues

Pension fund capitalism has been cited as influencing the development of corporate governance practices in the United States and the United Kingdom. The following article explains aspects of the structural changes to the Polish pension system and suggests, in terms of capital market development, how these changes might affect corporate governance.

Introduction

The objective of this article is to highlight the very basic landscape of the reform of the pension fund system in Poland, and the accompanying institutional change to demonstrate how this development might serve as a focal point for testing the health of corporate governance in Poland. This supposition is based on the experience of domestic savings and investments systems in developed markets, especially in the USA and the UK where the proportion of pension assets invested in equities was 46 per cent and 63 per cent respectively.1 The following sections cover: the economic environment and the case for reforming the pension fund system; the structural elements of pension reform including fund collection and investment activities; and some initial observations of activity under the new system. The article concludes by identifying areas of emerging issues, and where the most pressing of these is likely to develop in the future.
Pension funds

Within the new Polish pension system, capitalised contributions are managed and invested by specially licensed universal pension funds companies, which will run open pension funds. The Act on Organisation and Activities of Pension Funds (APF) created the legal framework for establishing and running pension funds companies, open pension funds, as well as employee pension funds. The pension funds are legal entities, created for purposes of accumulating and investing members’ money in order to supply funds at retirement. Three most important areas of their activities (receipts, organisation and investments) are subject to regulations, compliance with which is supervised and enforced by a newly created regulator – the Pension Funds Supervision Office (UNFE).

Receipts

The Act on Social Security System and Act on Pensions profoundly reformed the Polish pension system. In order to diversify the sources of retirement benefits, a new, three-pillar system was created. In the new system, the first pillar is simply the previous public pension system, the second pillar is based on private open pension funds, while additional and voluntary insurance and savings are contained in the third pillar. The core of the reform is therefore the creation of the second pillar, as the other two elements existed previously.

Under the second-pillar open pension fund, a contribution worth 7.3 percent of wages is redirected to capitalised open pension funds. At retirement, members of these funds will be obliged to purchase life annuities. However, this pillar will only cover all workers on a gradual basis. All persons starting their first job as well as those aged below 30 in 1999 must enter the new system, while those aged between 30 and 50 can choose either to stay solely with the first pillar or to split their contribution between the public first pillar and second-pillar pension funds.

The new system clearly assigns property rights to employees based on contributions accumulated during their working lives. Pension funds are obliged to provide members with regular information (at least once yearly) on their savings and the results of investment activities. This information has also to be disclosed on a member’s request. Funds collected for pension funds form part of a member’s personal estate for transmission on death, unlike funds contributed to the first pillar. This feature of the new system appeared to many to be a significant factor for splitting contribution between the first and second pillars.

Pension funds’ assets are kept by an independent bank-depositor, which is subject to a minimum €100 million capital requirement. The bank-depositor cannot be a shareholder in the depositing fund and cannot credit the fund for more than 1 per cent of the fund’s assets. The collection activities of funds are also directly regulated. In order to eliminate excessive promotion costs, which plagued similar funds in Chile and Argentina, it is forbidden to offer any additional benefits for joining the fund. A special register was created by UNFE, listing all sales people permitted to offer membership to funds. By mid-1999, the register contained more than 400,000 entries. Each entry has to be associated with a certain organisation. Salespeople can be employed either by the

Membership number (in millions)

Source: estimates based upon various issues of Konecznopolita

Membership of ten largest funds (estimated as of 15 July 1999)
universal pension company or by one of the entities allowed by the APF. These are: banks, insurance companies, brokers and State Mail.17

In addition, as part of the reform process, the existing first pillar as managed by the Polish Social Security Institution (ZUS) is undergoing significant changes. Contributions of each employee will be registered on their individual account. The retirement age will become an individual decision, with a certain minimum retirement age. Furthermore, all disability and survivorship benefits will remain within this pillar. The second pillar will therefore contribute only to pensions and according to official forecasts 35-40 per cent of future pension benefits will originate from this source.18

Funds organisation

Companies and funds are licensed and supervised by UNFE, and should fulfil numerous requirements, including a minimum capital value of €4 million19 which must be contributed in cash on establishment,20 and the shares must rank pari passu.21 Strict requirements also apply to board membership and persons responsible for investment decisions,22 and all arrangements with entities that are important for funds activities.

In effect, the form or regulation extends all the way through the investment process, i.e., custodian, brokers, etc., are also subject to UNFE scrutiny which requires a three-year business plan.23 Any entity may be a shareholder in only one pension funds company.24 This created some controversy in the case of one bank, which was simultaneously directly involved in one company, while holding another company’s shares in the form of global depository receipts. The APF also envisages detailed procedures in cases of funds acquisitions, mergers and liquidation.25

The licensing process was closed at the end of June 1999 and 21 funds were licensed, including those created by foreign firms such as Commercial Union, Nationale Nederlanden, Norwich Union and Allianz, and numerous domestic banks and insurance companies. Four applications were rejected for various reasons, but generally on the grounds that in the UNFE’s opinion, the shareholders could not ensure that the fund’s operations would appropriately secure the interest of the fund’s members.26

Investments

All pension companies and their respective open pension funds are subject to strict regulatory supervision. Investments of pension fund assets are also highly regulated. Restrictions on the investment of open pension fund assets are to be as follows:27

- 7.5% in recompensation vouchers (a special instrument that will be created to compensate certain state employees and pensioners for a lack of prescribed salary increases in previous years);
- 20% in bank deposits and bank’s bonds and other papers;
- 40% in shares listed on the stock exchange but no more than 10% on parallel (second) market (for smaller firms) and no more than 10% of all shares issued by one entity (excluding preference or other atypical types of shares);
- 10% in shares traded on regulated over-the-counter, allowed for public trading;
- 10% in National Investment Funds shares, in investment certificates issued by funds and fully secured bonds issued by other than municipalities entities;
- 15% in mutual investment funds units, other bonds publicly traded, particularly issued by municipalities;
- 5% in non-listed bonds and other papers;
- 5% in other types of investment including real estate and investment abroad.

These limits, coupled with minimum investment returns requirements imposed on funds, will significantly affect the investment pattern of pension funds. The APF defines the situation as a shortfall in fund.28 This situation arises when the rate of return for the last two years is lower than the minimum required rate of return. The minimum rate is equal to one half of the weighted average of all funds’ rate of return or is lower by 4 per cent from this average, whichever of these values is lower.29 A shortfall must be covered primarily from a fund’s reserve funds, which should be created within the fund and amount to 1-3 per cent of assets, depending on their volume.30 If this fund is not sufficient, the universal pension fund company will have to cover the shortfall from its own sources within 14 days.31 If these funds are also

![Portfolio of selected open pension funds (as of 30 June 1999)](image-url)
activity were marked by a vigorous advertising campaign on 1 April 1999. The initial months of their three months and their inauguration took place plagued by several delays. First, the date of penalties imposed by UNFE.35 obligations can expose the fund to heavy covered from the central guarantee fund.32 in Poland during this period. By mid-July some 25 per cent of all advertising spending a campaign, which was estimated to amount to some 25 per cent of all advertising spending in Poland during this period. By mid-July some 5 million people had signed up to funds, insufficient, the pension fund is to be liquidated and its obligations are primarily covered from the central guarantee fund.30 However, this fund is only limited to 0.1 per cent of all funds’ assets, so if the shortfall is more severe it is to be backed directly by the Treasury.29

It is expected that the relevant investment regulations will heavily influence funds’ investment decisions. Particularly, it is expected that a significant part of investment will be directed towards debt instruments, rather than equities. Fund managers will not have a lot of freedom to undertake riskier strategies while equity investments are still limited, among other things, by their low liquidity. According to preliminary statements on investment strategies in the start-up period, funds will be quite reluctant to involve significant amounts in equity instruments. Obviously, in the longer term, it is expected there will be a greater involvement in publicly traded equities because of the experience of developed economies.

The results of funds’ investment activity are to be published in various forms, including short monthly reports with a general split of investment portfolio, half-yearly reports with the list of all investments higher than 1 per cent of assets, and detailed yearly reports with lists of all investments.31 A failure to comply with these information obligations can expose the fund to heavy penalties imposed by UNFE.32

Reform developments

The introduction of reform, however, has been plagued by several delays. First, the date of pension funds activities was postponed by three months and their inauguration took place on 1 April 1999. The initial months of their activity were marked by a vigorous advertising campaign, which was estimated to amount to a total of 3.8 per cent. This situation expected to remain low for some time. In comparison with the previous PAYG system, the new one is evidently more costly to administrators. While administration of benefits within ZUS amounted to less than 3 per cent of contributions, the average fee charged on contribution by open pension funds remains within a 7-10 per cent band, although due to the impact of competition some funds have already lowered them from the original 15 per cent to between 8 per cent and 12 per cent. Additional charges are made on a monthly basis and depend on the volume of accumulated assets (up to 0.05 per cent monthly), types of investment made, etc. Additionally, overall system start-up costs (such as establishing the UNFE, the advertising campaign) were also considerable. However, these costs are expected to be covered by potential gains, associated with investment growth, as well as with overall increase in the volume of savings in the economy.33

Pension reform was regarded as one of the key issues in the process of Polish transformation and was introduced simultaneously with health sector and administrative reform. The initial concept for the reform surfaced...
on the eve of transformation.38 The final design of reform has taken place over the last three years, stimulated by political will to shake up the “old” system. However, after half a year of implementing the new system, results of public opinion surveys show that the new system enjoys even lower public confidence than the previous one. According to a GfK Polonia39 survey, in mid-July 1999 only 5 per cent of Poles strongly believed that the new system would provide them with fair pensions in the future (18 per cent were “quite confident”), while 14 per cent did not trust this system at all (16 per cent were “quite unconfident”). This underlines the necessity of disseminating information effectively that is central to pension reform inauguration.

Conclusion

Polish pension funds will accumulate long-term financial resources at a rapid pace, but their role in corporate governance is likely to depend on the development of the domestic capital market and the impact of regulations. Under the current framework, they will be pressured to adopt a policy of passive portfolios in an attempt to keep costs down and cope with the regulations on the minimum required rate of return. Moreover, a 10 per cent limit on funds’ participation in one entity will effectively reduce funds’ ability to influence significantly corporate governance structures in invested firms. Although the current lobbying efforts of funds focus on reducing, or disapplying, the required return mechanism and on increasing the limit on investment abroad, the limit on single investment in a company is likely to be the next cause for lobbying. As a result, a vacuum in corporate governance may emerge, with limited corporate accountability to shareholders, unless funds are given an incentive, and shareholders are permitted to become more actively involved in exercising their rights in corporate affairs and monitoring individual companies more intensively.40 In view of the current regulatory framework, their action in this area will require great coordination and perhaps cooperation with other players such as banks and investment funds. Although it might be expected that within the existing regulatory framework, pension funds will not play a very active role in corporate governance in the short term, they will surely play an indirect role by enriching and increasing the availability of information about the firms, which is crucial for financial market development. The disclosure of information is part of the process of developing corporate governance because it helps to facilitate the risk diversification policies of pension funds and thus improves their performance.

Lastly, it is worth underlining that in relation to pension systems, the EU has so far evaded implementing reforms. Poland, however, has taken these steps, at least in part, to facilitate the process of joining the EU and participation in monetary union. Budgetary reasoning lies behind these reforms, as social security spending is viewed as a major factor contributing to budget deficits and consequently high inflation. However, it is increasingly recognised that the social, economic and political issues which have driven radical pension system reform in Poland reflect not only Poland’s “transition” experience but also the experience of the wider and equally important global and regional communities. Moreover, it is possible to argue that insofar as central and east European countries such as Poland have moved much further with pension system reforms than their EU neighbours, their transition economies have entered unfamiliar territory as potential trendsetters, and their experience will also be valuable for their future EU partners.

Information on selected open pension funds (as of 30 June 1999)

<table>
<thead>
<tr>
<th>Name of open pension funds</th>
<th>Owner (%)</th>
<th>Total fund amount (million PLN)</th>
</tr>
</thead>
<tbody>
<tr>
<td>OFE Nationale Nederlanden</td>
<td>ING Continental Europa Holdings BV (80%) Bank Sazlki (20%)</td>
<td>4.013</td>
</tr>
<tr>
<td>Wirtenthuir OFE</td>
<td>Winterthur Life (70%) EBRD (30%)</td>
<td>0.343</td>
</tr>
<tr>
<td>OFE Ego</td>
<td>BIG Bank Gdanski (55%) Euroko BV (45%)</td>
<td>0.157</td>
</tr>
<tr>
<td>OFE BPH CU WBK</td>
<td>Commercial Union (80%) Wielkopolski Bank Kredytowy (10%) Bank Przemyslawa-K Audiowy (10%)</td>
<td>3.714</td>
</tr>
</tbody>
</table>

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39 See Rzeczpospolita 21.07.1999

Aspects of corporate governance in Russia

The rights and powers of the shareholders and boards of directors of Russian companies have recently attracted significant attention as a result of the exercise by the boards of certain companies of their powers to the detriment of shareholders. Foreign investors in particular have found themselves unable to control or influence companies in which they have a significant stake. There has also been a recent tendency for shareholders to exercise their rights to affect the ability of the board to pursue its policies of choice. This article explains the principal rights and powers of both the shareholders and the board of directors of Russian companies, both in theory and in practice. It also examines the key issues which relate to the structure and effectiveness of legal relations with the chief executive officer (CEO) in particular, and the management of such companies in general.
This article deals only with the corporate governance of joint-stock companies. This is one of the two most common forms of Russian company in which foreign investors are likely to invest. The basic legal framework for the corporate governance of such companies is set out in the Joint Stock Companies Law of 1996. The legislation governing limited liability companies is similar, although there are specific differences which affect the corporate governance of such companies.

Shareholders, the board and the CEO

Until the Joint Stock Companies Law came into effect in 1996, general meetings of the shareholders of Russian companies could determine any matter. The Joint Stock Companies Law limits the issues which can be determined by shareholders at general meetings to a specific list of matters,1 with all other matters being determined by the board or the management. The intention behind this legislation was to make the board a forum of authoritative decision-makers and were independent of the shareholders that sponsored their election. This intention is reflected in a number of provisions governing the election to, and the operation of, the board (for example, directors may only be appointed by general meeting not by specific shareholders).

As a consequence of the enactment of the Joint Stock Companies Law, while on paper the general meeting is still technically “the supreme management body of the company”, the management focus of the company has moved to the board of directors with the general meeting being perceived as a means of exercising shareholders’ rights rather than making business decisions.

Each Russian company is required to have a CEO who is appointed by the shareholders or the board depending on the constitutional document. CEOs of Russian companies have extensive powers in relation to the day-to-day running of the company. The role of the CEO and the management board and how the management structure can be modified are described in more detail below. Examples of the powers typically held by shareholders, the board and the CEO are set out in the table below.

Appointment of director

Appointment at the AGM

If investors wish to influence the business of a Russian company, it is necessary for them to obtain influence on the board of directors. Directors in Russian companies may be elected only by shareholders at the general meeting and may not be directly appointed by shareholders. Shareholders owning at least 2 per cent of a company’s issued share capital may notify the company of candidates for election to the board at the company’s annual general meeting (AGM) following the end of the previous financial year. The time-limits for making this notification are strict and if this notification is not received by the company by 30 January, the shareholders’ candidate or candidates will not go on the list of candidates for election to the board at the AGM. Given the long delay between the deadline for the notification of candidates for election to the board and the AGMs of Russian companies (which are usually held in June), it is quite possible for the list of candidates for election to the board to become inappropriate or unhelpful for any number of reasons, including shareholders having sold their shares in the company. Even if this is the case, there is no means of changing the candidates for election at the AGM once the time-limit for notification has passed without a serious risk of the validity of the elections being challenged by other shareholders.

Appointment other than at an AGM

The inability to appoint directors in a company after the date on which the list of candidates for election to the board at the AGM has been finalised is clearly a problem for any investor who buys a significant stake in a company after such date has passed.

Power distribution in a typical Russian joint-stock company

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Board</th>
<th>CEO</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Reorganisation and winding up</td>
<td>• Determination of the company’s strategy</td>
<td>• Executing contracts and other documents on behalf of the company</td>
</tr>
<tr>
<td>• Mergers and acquisitions</td>
<td>• Public offering of new shares</td>
<td>• Issuing powers of attorney to act on behalf of the company</td>
</tr>
<tr>
<td>• Amendments to constitutional document</td>
<td>• Appointment of the CEO and the management board and setting compensations therefor</td>
<td>• Day-to-day running of the company</td>
</tr>
<tr>
<td>• Authorised but unissued capital</td>
<td>• Establishing subsidiaries and branches</td>
<td>• Other matters not reserved for shareholders or the board</td>
</tr>
<tr>
<td>• Private offering of new shares</td>
<td>• Participation in non-group organisations</td>
<td>• Transactions with a value below 25% of the book value of assets</td>
</tr>
<tr>
<td>• Redemption of more than 10% of outstanding shares</td>
<td>• Payment of interim dividend</td>
<td>• Approval of personnel schedule</td>
</tr>
<tr>
<td>• Transactions with a value above 50% of the book asset value</td>
<td>• Recommendation in respect of annual dividends</td>
<td>• Orders to employees</td>
</tr>
<tr>
<td>• Related party transactions with a value above 2% of the book asset value</td>
<td>• Approvals of annual dividend</td>
<td></td>
</tr>
</tbody>
</table>

1. Without the shareholders’ resolution, the board may only consider matters which have been set out in the Joint Stock Companies Law.
shareholders receive a notice of the EGM, to the new board. There is no procedure for is entitled to present candidates for election at an EGM. In particular, it is unclear who mechanism for the election of a new board removal of directors, it is silent on the Stock Companies Law deals with the early Extraordinary general meetings (EGMs) which are specifically convened for the early re-election of the board are no longer unusual in Russia. Unfortunately, although the Joint Stock Companies Law deals with the early removal of directors, it is silent on the mechanism for the election of a new board at an EGM. In particular, it is unclear who is entitled to present candidates for election to the new board. There is no procedure for the board to ask shareholders for candidates to be considered at an EGM and by the time shareholders receive a notice of the EGM, the draft resolutions, including the list of candidates, should have already been approved by the current board. The situation is even more complex if the company’s board is elected by cumulative voting (see below). This is because the resolution for the early termination of directors’ powers may be passed only in respect of all members of the board. That means that the whole new board is at stake. Various interpretations have been applied to the legislation to deal with this lacuna. For example, the provisions of the Joint Stock Companies Law that entitle shareholders to present candidates to the board for election at an AGM are sometimes interpreted to mean that shareholders are not entitled to present candidates for election as directors at an EGM. However, this interpretation would mean that candidates to the new board could be nominated only by the current board, which would contradict the spirit if not the letter of the Joint Stock Companies Law. There is no simple answer which allows the appointment of a new board nominated by shareholders at an EGM without a risk of either a removed director or a shareholder bringing a claim disputing the legitimacy of the new board. The best way of reducing the risk of a challenge to the appointment of a new board at an EGM is to give shareholders notice of the proposed re-election of the board and allow them a reasonable period of time (one month, for example) to present their candidates before the board finalises the draft resolutions and actually convenes the EGM. This solution is available only where the current board is co-operative. In practice, if the issue is not contentious, people tend to agree the list of candidates with other shareholders concerned informally. The situation is much more complicated if the board is reluctant to convene an EGM for the re-election of the board and the investor has to demand that such an EGM be convened. In these circumstances, although the board is under a statutory obligation to comply with the demand, it is under no obligation to give other shareholders an opportunity to present candidates for a new board. It may also be technically difficult for them to do so, as the board is obliged to convene such an EGM within 45 days from the date of the demand. Voting at general meetings to maximise board representation Russian law allows shareholders to elect the board through cumulative voting. This means that shareholders have their usual number of votes multiplied by the number of seats on the board and may distribute such multiplied votes between candidates as they wish. Cumulative voting is compulsory for companies with more than 1,000 shareholders and has also been adopted by many Russian companies with fewer shareholders. While cumulative voting should in theory ensure that shareholders obtain a presence on the board which reflects the size of their shareholding, it does not always achieve this result in practice. Representation on the board may be affected by less than 100 per cent of votes being cast as voting tactics are usually predicated on all votes being cast. In addition, many shareholders consolidate their voting powers with other shareholders and spread votes equally between agreed candidates of both parties to achieve a greater representation on the board. Shareholders’ control and influence on incumbent board Appointment of the CEO The relationship between the shareholders and the board is often determined by which of them has the authority under the constitutional document to appoint and remove the CEO. The Joint Stock Companies Law permits the CEO to be removed at any moment without cause. Therefore, the body with the power to make the appointment can directly influence the day-to-day management of the company. This is often more important than the ability to make strategic decisions. Generally, where the CEO is elected by shareholders, the CEO’s position vis-à-vis the board is more balanced, with the CEO and managers of the company being more independent of the board. However, appointment by the shareholders makes it difficult to change the CEO and the rest of the managerial team. This can be a particular problem for investors seeking to consolidate a team of non-executive directors (the members of the board) and executive directors (the CEO and other managers) or to concentrate the decision-making processes of the company within the board.
Focus on corporate governance

provides for a higher affirmative requirement.

another EGM preceding the one demanded
the date of the demand, it can convene
proposed resolutions but may add its own
an EGM be held. In such circumstances,
resolutions and choose the order of the items
of the company's shares may demand that
party transactions.

to vote on approval of each other's interested
party transactions.

Shareholders owning 2 per cent of the company's share capital may propose items for the agenda at the AGM.

This right is, however, limited to a maximum of two items and may be exercised within a strictly limited period of time. The board may put as many items onto the agenda of an AGM or an EGM as it considers appropriate.

In addition, the board may decide on the order of items on the agenda. This can be very important in certain circumstances, such as when different groups of shareholders have to vote on approval of each other's interested party transactions.

Shareholders owning at least 10 per cent of the company's shares may demand that an EGM be held. In such circumstances, the board may not change the wording of the proposed resolutions but may add its own resolutions and choose the order of the items on the agenda. Although, the board is obliged to convene such an EGM within 45 days from the date of the demand, it can convene another EGM preceding the one demanded by the shareholders.

Shareholders' blocking rights

The most effective way in which those shareholders who do not control the board can influence or limit the actions of the board is to block resolutions which the board must refer to the general meeting.

Shareholders often use their power to block resolutions proposed by the board in order to protect their interests (for example, preventing the board from effecting a new issue of shares which would dilute the value of existing holdings, or selling significant assets). However, the effectiveness of such blocking resolutions can be limited. This is best illustrated by reference to an example.

One of the most frequently discussed examples of major practice in Russian companies is the sale of the relevant company's valuable (sometimes core) assets to a related party for doubtful (sometimes zero) consideration (see below). Such sales have been effected recently by the boards of companies in circumstances where those boards have failed to make the company a wholly-owned subsidiary of a majority shareholder's group, or in order to retain control over the assets in anticipation of the company's insolvency. In theory, shareholders can prevent such transfers of assets. Most transactions with a value exceeding 2 per cent of the company's book asset value with an interested party are subject to shareholders' approval prior to its becoming effective; the interested party is prohibited from voting on the approval. However, in practice, such transactions will often not be put to shareholders for approval as they have been structured so that the person with whom the company is dealing is allegedly outside the statutory definition of an "interested party". Although the requirement covers affiliated persons of an interested party by reference to the anti-monopoly legislation, the definition of an "affiliated person" is, though relatively comprehensive, difficult to enforce (and in the case of affiliated entities incorporated outside Russia, almost impossible). In addition, affiliation is sometimes effected through individuals so that it is virtually unenforceable and the requirement becomes consequently unenforceable.

Blocking resolutions at general meetings are also used with a view to putting pressure on the board by shareholders. As there are many technical or formalistic matters which require approval by shareholders under the terms of the Joint Stock Companies Law, there are many opportunities for this pressure to be applied. For example, shareholders can block a new share issue by a company (even though the issue is on fair terms and is proposed to bring much-needed cash to the company) in a situation where they do not have the funds to subscribe for additional shares and would prefer to see the company stagnate than see their shareholdings being diluted. While such shareholders may not have enough votes to block a resolution on the share issue (which requires 50 per cent of votes cast at the meeting) they may have enough votes to vote down formalistic approvals required for both major and interested-party transactions which carry higher affirmative requirements and which have to be passed before other shareholders may buy additional shares.

Matters which require approval by a three-quarters majority of votes cast at a general meeting include amendments to the charter, approvals of the amount of the authorised capital and major transactions. Consequently, significant shareholders in Russian companies seek to obtain control of over 75 per cent of voting shares by the company even if they enjoy a strong presence on the board. Conversely, minority shareholders will generally try to consolidate their voting powers up to a blocking vote of 25 per cent of the voting stock plus one share.

Releasing shareholder value

One of the most recent trends is the attempt by shareholders, who have bought a company's shares at historically high prices, to force the company to redeem their shares using the statutory requirement for a mandatory offer by the company to buy out its shareholders. Such an opportunity arises when the company undertakes certain actions triggering the requirement to buy out shareholders who voted against them or did not vote. Such actions are as follows:
(i) a reorganisation of the company; (ii) the entering by the company into a major transaction which has a value exceeding 50 per cent of the book value of its assets;
and (iii) the passing of an amendment to the company’s charter that limits shareholders’ rights. It is not clear from the Joint Stock Companies Law whether the buy-out requirement is triggered by the actual reorganisation or major transaction or by the mere shareholders’ resolution to approve that reorganisation or transaction. Some provisions of the statute suggest that it is the reorganisation or major transaction becoming effective10 whereas other provisions, such as those which describe the procedure for the buy-out, envisage that shareholders may exercise their put option within 45 days from the date of the relevant resolution.11 So far as charter amendments are concerned, shareholders attempting to force the company to buy out their shares would interpret any amendment, however technical, as prejudicing their rights and try to persuade the court accordingly.

**Company accounts**

As well as the difficulties that investors may face in influencing the operation of Russian companies, investors also need to be aware of the difficulties that they may experience in checking the adequacy of the financial information about the companies in which they invest.

The board is generally accountable to the shareholders for the publication of annual accounts at the AGM. In case of open joint-stock companies, annual accounts must be reported upon by an independent auditor. 12 As regards time between AGMs, although the Civil Code entitles shareholders owning 10 per cent of a company’s shares to request the publication of the accounts by an independent auditor at any time, this may be difficult to achieve in practice. Although the Civil Code refers to the Joint Stock Companies Law for the procedure for conducting such reviews, the Joint Stock Companies Law does not mention them. In these circumstances, even if the board were to allow such a review, it would be under no obligation to respect the shareholders’ choice of auditor.

If shareholders have a concern about the accounts of a company, a more realistic option is to request that the company’s accounts be reviewed by the internal Audit Commission. This request can be made at any time by shareholders owning at least 10 per cent of shares. The Audit Commission is elected by shareholders at each AGM to supervise the company’s financial and business performance and is independent of the board. The Audit Commission is entitled by law to request from the management any documentation relating to the company’s financial standing. This potentially powerful body has historically been underutilised by the shareholders of most Russian companies and interim reviews of company accounts initiated by them have been rare. The quality and impartiality of the review will depend on whose representatives are on the Audit Commission. Shareholders are also entitled to propose candidates to the Audit Commission as well as the board for appointment at the AGM. One seat on the Audit Commission may not necessarily solve the problem of access to the company’s accounts, but it does increase shareholders’ chances of obtaining a better picture of the company’s financial position.

**Directors’ duties and responsibilities**

It is a feature of corporate governance in a number of jurisdictions that directors are under specific statutory or common law duties to shareholders or the company. It is also often an area explored by investors when seeking relief for the actions of boards which do not appear to be acting in the best interests of the company. Under the Joint Stock Companies Law, directors are required to act in the interests of the company and perform their duties regarding the company reasonably and in good faith.13 This requirement provides only a vague and difficult to enforce basis for the protection of minority shareholders and this is reflected in the reluctance of minority shareholders to seek protection for their rights on these grounds. Neither the Russian legislators nor the courts have so far produced a clear notion of good faith that can be applied to directors’ actions. Thus, in the

10 Joint Stock Companies Law §75.

11 See id. §76.

12 An open joint-stock company is defined in the Joint Stock Companies Law as one whose shares may be allocated without consent from other shareholders, and which may carry out public offerings of its shares.

13 This largely depends on the procedure for the operation of the Audit Commission that is established by the general meeting of shareholders.
Focus on corporate governance

absence of commonly applied tests, it appears that a minority shareholder will have a sustainable cause of action only where a board's action or decision has been either negligent (see below) or plainly irrational.

It seems, however, that the problem of directors' actions lies deeper than just in the simplicity of the statutory provision. It has to be recognised that if directors are appointed by a particular group or interest they will owe allegiance to that group or interest which will affect their actions.

The situation may take time to improve and that improvement may depend on the holding of assets by different groups becoming more settled. A lot, of course, will depend on how the relatively new concepts of the duty of loyalty to the company and acting in good faith are interpreted and developed by the judges over the next few years as well as by the readiness of those judges to go into details of a particular situation and exercise their discretion.

Under the Joint Stock Companies Law, directors are liable to the company for any damages inflicted on the company through their negligent action or omission. The company or a shareholder owning at least 1 per cent of the company's ordinary shares has the right to bring an action against a director for the damage caused by that director to the company.

Common abuses of board power

Dilution of interests in the share capital of the company

Much recent discussion has centred on the dilution of minority shareholders in Russian companies in circumstances where, for example, major shareholders have been seeking to make the company their wholly owned subsidiary by forcing out those minorities. Historically, this has been achievable because shareholders in a Russian company did not have pre-emption rights in respect of shares placed through a private offering. As a consequence, shareholders were not consulted when the board was planning to issue shares to a new investor or to increase the shareholding of only some of the existing shareholders. As a consequence of the abuse of shareholder rights, amendments were made to the Standards of Share Emissions in April 1998, which significantly limited the ability of the board of a company to issue new shares by a private offering or at its discretion. A private offering, and, rather unusually, a pro rata offering to existing shareholders, now requires shareholders' approval. The recently published Law on Protection of Rights and Lawful Interests of Investors on the Securities Market has also increased the limitations on private placements of shares. The placement of new shares through a private offering is now generally subject to approval by a two-thirds majority vote of shareholders and requires the company to redeem the shares of those shareholders who vote against the resolution or did not vote.

The value of the shares to be issued may also affect existing shareholders since it determines, for example, the amount of funds that shareholders need to put up in order for their share not to be diluted. The Joint Stock Companies Law requires new shares to be issued at their market value as determined by the directors. The Standards of Share Emissions provides for three occasions when an independent auditor should be engaged to determine the market value of shares of an open joint-stock company to be placed through a private offering. These are:

(i) when the offer is intended to be addressed to a person who is not an existing shareholder;
(ii) when the shares are intended to be issued other than pro rata to existing shareholders;
(iii) when the shares are intended to be issued other than pro rata to existing shareholders.

However, due to the board's discretion in relation to determination of the market value, it is not strictly obliged to apply the valuation supplied by the independent auditor. Consequently, deviation from a "subjective" evaluators' opinion towards a more "objective" estimation can easily be justified in the context of the business as a whole. In the context of a rights issue, the board may, for example, come up with a figure that is advantageous to certain shareholders or discourage other shareholders from taking up their rights to additional shares.

Dilution of shareholders’ interests by payments in kind

Investors in some Russian companies have also been subject to dilution in circumstances where new shares have been issued for low or even zero consideration to a majority shareholder or related person. Although the Joint Stock Companies Law provides that shares should be paid up in full, the reality is that while the obligation is formally satisfied, the company may still receive zero value in exchange for its shares. This is commonly achieved by payment for shares in kind (for example, with debt instruments such as promissory notes, etc.). The market value of such non-cash consideration must be established by the board of directors. There is a requirement for an independent auditor to be contracted to evaluate a non-cash consideration if the nominal value of shares to be paid up with such non-cash consideration exceeds a statutory limit (200 times the minimum statutory monthly wage). However, it is often relatively easy to obtain independent valuations that debt instruments have a value of exactly the amount that needs to be paid for the new shares. Needless to say, a share issue that gives permission to pay up shares in kind is often also a share issue to dilute other shareholders’ interests.

The CEO and the management board

peculiarities of the CEO’s office in a Russian company

It is difficult to underestimate the importance of the CEO (usually called the President or the General Director) in a Russian company. Even where the CEO is appointed and hence closely controlled by the board, the CEO has significant power in terms of the day-to-day
running of the company. In joint-venture companies, a shareholder who exercises influence on the CEO will be at a distinct advantage to his joint-venture partner or partners. No officers of a Russian company (other than the CEO) can by their actions bind the company vis-à-vis a third person unless they have a written power of attorney from the CEO. Although the signature of the chief accountant is also required to enter into any financial obligation of the company, the chief accountant is, in practice, likely to concur with the CEO.

The CEO is personally liable for breaches of legislation by the company. The rationale for this personal liability is that there must be somebody who can be held personally responsible for violations of various administrative and other requirements. In particular, legal entities other than people may not be subject to criminal liability under Russian law. Since all actions on behalf of the company are deemed to be either undertaken or otherwise authorised by the company's CEO, the CEO is deemed to be a priori responsible for them all. The liability of the CEO for certain breaches of legislation can be very severe. Particular examples of personal liability of the CEO include breaches of currency control legislation, or those imposed under insolvency law.

Apart from the CEO, a Russian company may also have a management board, an executive collegiate body undertaking day-to-day management. Although in theory the management board should act as a check on the powers of the CEO, in reality the management board usually comprises the CEO's nominees and is under his or her control. Therefore, currently the CEO and the management board are often perceived as a single body in terms of the decision-making process.

The matters on which the CEO and the management board have power to make decisions are defined in the Joint Stock Companies Law as all issues relating to the company except issues reserved to the board. This comprises a wide range of issues, which can be as important as those reserved to the board. The board is generally not in a position to control the actions of the CEO. Therefore, although perfectly lawful, they may drive the company into insolvency.

On the other hand, such concentration of both important and technical responsibilities with one individual often leads to ineffective management. It stimulates the growth of various consultative bodies under the CEO with poorly defined roles and virtually no responsibility. Although the management board was envisaged as a forum for collective decision-making, it rarely fulfils this role because members of the management board often depend on the CEO for their position and are discouraged to be proactive on particular managerial issues.

Shareholders' relationship with the CEO and the management board

Many investors, especially foreign investors, are considering changing the structure of corporate governance in their companies to ensure more effective board or shareholder control over the company's management and to improve the distribution and delegation of authority within the company. There are significant constraints to improving corporate governance in Russian companies. Many statutory provisions regulating corporate governance are of a mandatory nature. While logical at first glance, they are often construed in such a manner that they impose unnecessary restrictions or dictate certain features which would not otherwise be desirable.

The most difficult problem facing an investor who is looking at changing the way in which a company is managed is how the board or the shareholders can effectively control the CEO and how to enable managers other than the CEO to operate effectively without being dependent on the CEO.

While the jurisdiction of the shareholders of a company is limited by the Joint Stock Companies Law, the jurisdiction of the board is not. Therefore, the constitutional document of a company may reserve to the board any managerial issue which would otherwise come within the mandate of the CEO and the management board. If having taken a matter from the CEO's mandate, the board can either deal with it for itself or delegate it to a particular executive or committee who will report to the board.

Even if the board has appointed a number of executive officers who can effectively run the company, there is still a requirement for a CEO under the Joint Stock Companies Law and the post may not be abolished. However, there is nothing to stop the CEO being merely another executive with his or her own area of responsibility or purely holding the position of "statutory" CEO. Alternatively, it is equally possible to combine the statutory role of CEO with the ultimate responsibility for the company's operations and coordination of some or all other executives' activity. Whichever option is adopted, the peculiarity of the "statutory" CEO's office and his or her exposure to liability for breaches of legislation by the company cannot be removed.

As there is no legal requirement for a management board, it can be abolished. Alternatively, it may be adapted for the new structure perhaps as an executive committee or a CEO's committee. There are, however, certain issues that have to be considered if the management board is to be so reorganised. The management board, as it is envisaged in the Joint Stock Companies Law, is a formal body and that inevitably creates a degree of bureaucracy. It also lacks comprehensiveness and may fail to accommodate more specific forms of executives' forum. In general, it may
Focus on corporate governance

be easier to create new forms of consultation and collective decision-making than to adopt this statutory body.

Enabling executives to act vis-à-vis third parties without referring to the CEO is an important feature of companies outside Russia. It cannot be achieved as a matter of Russian company law, but the Russian Civil Code concept of agency can be utilised. The CEO can issue executive officers with formal powers of attorney enabling them to act on behalf of the company within the limits of their individual authority. This arrangement could give a degree of instability because as a matter of Russian law, a power of attorney may be withdrawn at any moment (even if it says otherwise) and because the maximum period for which a power of attorney may be issued is three years. This is less of a problem if, as part of the arrangement, the CEO is effectively obliged to issue and maintain such powers of attorney. If the CEO does not comply with this requirement, he may be removed by the board (provided that, under the constitutional document, it is the board which appoints him).

There are of course limitations imposed by the statutory framework which cannot be adapted to a more investor-friendly style of corporate governance. As well as the statutory duties of the CEO, even if the corporate governance of a Russian company is restructured in the way described above, there can be no guarantee that the CEO will not take an action vis-à-vis a third party and hence bind the company outside his reformed authority, and there is little a company can do to prevent such an action. Even if the constitutional document of a company limits the CEO’s powers, the actions of the CEO vis-à-vis a third party taken in breach of such limitations would still bind the company unless it can prove that the third party “knew or should have known” about the limitations.
Legal transition developments

Legal transition developments

Albania

**LEGAL DEVELOPMENTS**

**Capital markets**

A new regulation defining the functions and activities of the supervising board of the Tirana Stock Exchange (TSE) was approved in April 1999. According to the regulation, all the activities of the TSE would be run by the Supervising Council of the Central Bank of Albania (CBA), which would be presided over by the governor of the CBA. Other members would be the chief of the TSE, a representative from the Ministry of Finance, and stock exchange dealers selected by the governor of the CBA.

**Telecommunications**

The Council of Ministers of Albania has adopted a decision on 16 June 1999 by which it has approved the Telecommunications Sector Policy. This policy, which has been prepared with EBRD assistance, outlines the short-term and medium-term objectives of the government in terms of telecommunications policy, and announces the intention of the government to liberalise all telecommunications services by 2003 and its decision to privatise both the incumbent operator, Albtelecom, and the GSM operator, AMC, by the end of 1999. Furthermore, the decision describes the government’s policies towards the development of telecommunications in the rural areas, and its approach to licensing, interconnection, numbering and frequency management. Lastly, the policy also addresses the issue of tariff regulation, including the actions the government intends to take in order to rebalance tariffs in a socially acceptable manner.

Armenia

**LEGAL DEVELOPMENTS**

The Law on the State Registration of Property Rights was ratified on 30 April 1999. The law regulates the right of state registration of property and the operation of the system implementing the state registration.

The National Assembly of Armenia adopted the Law on Leasing Activity. The law determines relations with distributors as well as between different enterprises. Entrepreneurs who use equipment leases are given tax privileges for three years.

Armenia is moving towards accession to the World Trade Organization (WTO), originally scheduled for early 1998. Accession will mean that Armenia’s laws should become more in line with international standards and will make the country more attractive for foreign investments. The accession process will require that Armenian competition laws be changed as well as laws on monopolies, businesses, industrial policy, accounting, financial markets and financial institutions.

Belarus

**LEGAL DEVELOPMENTS**

**New Civil Code**

The new Civil Code came into force on 1 July 1999. It is based on the CIS Model civil code, which served as a model for the Russian, Uzbek, Kazakh, Kyrgyz and several other civil codes. It introduces and governs a variety of corporate vehicles for businesses and securities, regulates property and property rights, contracts and intellectual property rights, and contains basic rules on international private law. The new Code also regulates pledge and mortgage issues, introduces the concept of insolvency, and provides for the ranking of claims of creditors upon liquidation of a legal entity.

Czech Republic

**LEGAL DEVELOPMENTS**

**Capital markets**

According to the new requirements of the Prague Stock Exchange (PSE), effective as of 28 June 1999, companies with shares on the PSE’s main and parallel markets will have to disclose to the public certain information about their subsidiaries, as well as on the volume of outstanding loans, including the names of the creditors. Significant changes in management personnel control or on a company’s board of directors must also be reported. Companies now must also inform the PSE in a timely fashion of any changes in their financial situation that might affect the price of their securities.
Focus on corporate governance  

Law in transition

LEGAL REFORM PROJECTS

Close-out netting legislation
At the request of the Czech National Bank, the EBRD is undertaking a project to assist the Czech Republic in developing legislation to strengthen the enforceability of close-out netting for over-the-counter (OTC) derivatives contracts.

Hungary
LEGAL REFORM PROJECTS

Close-out netting legislation
At the request of the Ministry of Finance of Hungary, the EBRD will initiate a project to assist Hungary in developing legislation to strengthen the enforceability of close-out netting for OTC derivatives contracts. This project will begin later this year.

Kazakhstan
LEGAL DEVELOPMENTS

Further Policy on the Tenge Exchange Rate
The Statement of the Government of the Republic of Kazakhstan and the National Bank of the Republic of Kazakhstan on Further Policy on the Tenge Exchange Rate was signed by the Prime Minister and the Governor of the National Bank on 5 April 1999. The Statement adopts the regime of a free-floating exchange rate of the tenge as the most appropriate regime under the current condition of Kazakhstan’s open economy and the unstable conditions in the international financial and commodity markets.

Programme to attract foreign investment
The Kazakh Cabinet has developed a programme for attracting direct foreign investment in 1999–2000. The programme includes principles of stability and the enforceability of close-out netting for OTC derivatives contracts.

Tax Code amendments
Broad amendments to the Tax Code were made in March 1999. The amendments establish new taxes and fees, increased rates for some taxes and changed administration in favour of taxpayers.

LEGAL DEVELOPMENTS

Law on Investment Funds
The Law on Investment Funds was passed by the parliament in June 1999. The law allows for the establishment of mutual funds and defines investment instruments in which an investment fund may invest. The National Securities Commission will issue licences to investment funds and will oversee their activities.

Decree on development of securities
The President of Kyrgyzstan signed a decree on measures to develop the securities market on 13 May 1999. The decree aims at ensuring transparency of the market in order to attract greater investment in securities.

Kyrgyzstan
LEGAL DEVELOPMENTS

Moldova
LEGAL REFORM PROJECTS

Developing Moldova
securities markets
At the request of the National Commission for Securities of Moldova (MNCS), the EBRD is developing a project to assist the MNCS in developing and improving the relevant legislation regarding the Moldovan securities markets.

Poland
LEGAL DEVELOPMENTS

Capital markets
A new pension system came into force on 1 January 1999, which substituted the previous system. Under the new tri-pillar system, the sources of financing for future pensions are diversified.

Company law
A new draft of the law on companies was published in early 1999. Although it has not yet been introduced in the parliament, the draft indicates the direction of developments in Polish company law. One of the important tasks of the new legislative efforts is to adapt the Polish law to current market requirements and to harmonise the national law with EU standards.

LEGAL REFORM PROJECTS

Close-out netting legislation
The EBRD is planning a project to assist the Polish authorities in developing legislation to strengthen the enforceability of close-out netting for OTC derivatives contracts.
The new Law on Legal Treatment of Security Interests in Personal Property was published in the Official Gazette on 27 May 1999 and is of security interests in personal property. Interests in Personal Property was published into law in June 1999. Under this law, items subject to taxation are: residential houses, flats, holiday homes, garages and other premises and structures, as well as aircraft, helicopters, ships, yachts and other air and water transport vehicles.

New privatisation law
The previous privatisation regime has been amended. The new law aims to liberalise the privatisation programme and accelerate the process of moving state assets into the private sector.

Possessory pledges governed by the Civil Code are still effective.

Restructuring of Credit Organisations
The Law on Restructuring of Credit Organisations was enacted in July 1999. The Law introduces the Agency for Restructuring of Credit Organisations (ARCO) as a state-owned corporation. Under the law, a lending institution may be reorganised if it holds not less than 1 per cent of the total amount of personal deposits at lending institutions in Russia as a whole, or if its assets constitute not less than 1 per cent of total assets of all Russian lending institutions. The law empowers ARCO to take decisions on measures to financially rejuvenate lending institutions, to increase or decrease the charter capital of a lending institution, and to make decisions on lending institution reorganisations.

ARCO may also sell or convey the rights to shares in lending institutions, grant loans, make deposits, grant security, render other financial assistance to lending institutions, and liquidate lending institutions. The federal authorities, the authorities of constituent members of the RF, the local authorities and the Central Bank of Russia "do not have the right to interfere with the activities of ARCO."

Law on Amendments and Additions to the Law on Property Tax for Individuals
The Law on Amendments and Additions to the Law on Property Tax for Individuals came into force in July 1999. According to this law, items subject to taxation are: residential houses, flats, holiday homes, garages and other premises and structures, as well as aircraft, helicopters, ships, yachts and other air and water transport vehicles.

LEGAL DEVELOPMENTS

Regional

LEGAL REFORM PROJECTS

CIS model securities law
Since 1994, there has been a process of harmonisation of commercial legislation within the CIS member states, supported by the Inter-Parliamentary Assembly of the CIS.

In July 1999, the EBRD approved a new technical assistance project to develop the CIS Model Securities Laws. The objective of this project is to upgrade parts of the legal environment for fostering economic reform in the CIS member states, in order to facilitate and promote a well-organised, modern, efficient capital market, as well as to achieve high standards in the protection of rights of security holders. This objective will be met through the development of various model laws dealing with all aspects of the securities market, including transactions with securities, their clearance and settlement, professional participants in the capital market, regulator's authorities and licensing.

The project will be implemented by the Dutch Centre for International Legal Cooperation together with the Leiden University Institute of Eastern European Law and Russian Studies and the CIS Centre for Private Law.

Romania

LEGAL DEVELOPMENTS

Legislation was passed in May to accelerate economic reform in Romania (Law No.99 of 26 May 1999). It covers the following areas:

New pledge law
The new Law on Legal Treatment of Security Interests in Personal Property was published in the Official Gazette on 27 May 1999 and is scheduled to come into force on 26 August 1999. It governs the creation, priority and enforcement of security interests in personal property.

Law on Specifics of Insolvency
The Russian Law on Specifics of Insolvency (bankruptcy) of natural monopolies active in the fuel and energy industries was signed into law in June 1999. Under this law, certain restrictions apply in relation to bankruptcy of debtor enterprises that make products of strategic importance for the Russian economy, plants that constitute the core of the economy of towns or state unitary enterprises.
Law on Foreign Investment in the Russian Federation

The Law on Foreign Investment in the Russian Federation was enacted in July 1999. The law specifies investment projects that are eligible for special legislative regimes and sets forth criteria for selecting investment projects that can enjoy favourable treatment. Specifically, projects with total foreign investment at least Rb 1 billion, and commercial organisations with a minimum foreign share in the capital of no less than Rb 100 million qualify for that treatment. The list of projects has to be approved by the government. The law also envisages guarantees against any changes in Russian legislation unfavourable for foreign investors. Guarantees apply to foreign investors and commercial organisations with foreign investment if the foreign holding in the capital exceeds 25 per cent. For industrial and infrastructure projects in which investments are recouped in a period of more than seven years the government will extend the term of "legislation stability" guarantees. If a foreign investor fails to meet obligations he has assumed he will no longer be eligible for concessions set out by the law.

Tax reform

In April 1999 there were some amendments and additions made to the Federal Tax Legislation, including to the Corporate Profits Tax Law and VAT Tax Law. The amendments include reduction of profit tax rate, tax registration and profit tax payment requirements for foreign companies, new tax exemptions, and Value Added Tax issues. On 31 March 1999, the President signed (1) the Federal Law on Amendments and Additions to the Law on Tax on Profit of Enterprises and Organisations, and (2) the Federal Law on Amendments and Additions to Individual Legislative Acts of the Russian Federation on Taxes. These laws came into force on 1 April 1999. According to these laws profit tax rate for most companies is reduced from 35 to 30 per cent. The rate for profit from intermediary activities and for banks and insurance companies is reduced from a maximum rate of 43 per cent to a maximum rate of 38 per cent. The maximum regional profit tax rate is reduced from 22 to 19 per cent for most companies, and from 30 to 27 per cent for profit from intermediary activities and for banks and insurance companies. The fixed federal profit rate is reduced from 13 to 11 per cent.

Starting from 1 April 1999, foreign companies are required to calculate their profit tax liability on a quarterly basis and make payments monthly. The options of calculating profit tax on a monthly basis and making payments once per month have not been extended to foreign companies.

Amdends to the VAT (value added tax) law that came into effect basically introduce some technical changes.

LEGAL REFORM PROJECTS

Capital markets support

Under the auspices of the Joint EU/EBRD Russia Task Force a technical assistance project has been approved to provide for up to six legislative workshops on proposed capital market reform. It is very important to build a consensus among participants in the market and decision-makers in the government and legislature.

This project aims to communicate the initiative embodied in draft legislation developed under an EBRD-sponsored project and educating members of the parliament, particularly deputies in the Duma, with respect to the need for this new legislation based on an international practice, the effect that this new legislation would have on the securities market; and the legal consequences of the current drafts and any different wording that might be proposed.

Slovak Republic

LEGAL REFORM PROJECTS

New financial market supervisory authority

At the request of the Finance Ministry, the EBRD is planning to undertake a project to assist the Slovak Republic in establishing and developing a new financial market supervisory authority for the Slovak financial markets.
Slovenia

LEGAL DEVELOPMENTS

Capital markets
A new securities law, which came into force on 24 April 1999, obliges all companies that sold their shares publicly to register them at the central registering company KDD in 60 days.

Secured transaction
The procedure for perfecting the security interest created over properties pledged now has to include a notarisation with the notary public.

Turkmenistan

LEGAL DEVELOPMENTS

Law on Licensing of Certain Types of Activities
The Law on Licensing of Certain Types of Activities entered into force as of 16 June 1999. The law determines the legal basis for licensing certain types of activities, state bodies issuing licences, licence requirements and the list of activities that require licences.

Uzbekistan

LEGAL DEVELOPMENTS

Decree on privatisation
The Uzbek President signed a decree in May 1999 on privatisation which tightens control over the implementation of privatisation. The decree specifies objective and subjective factors that guide privatisation activities implemented in accordance with governmental decisions. The State Property Committee allocates revenues from privatisation according to the scheme on a monthly basis.

Decree on procedure of liquidating enterprises
The President signed a decree on measures intended to simplify the procedure of liquidating enterprises on 29 June 1999. The decree authorises regional administrations to set up permanent commissions within two weeks for liquidating enterprises that have ceased their activities and failed to form registered funds by the legally prescribed dates.

LEGAL REFORM PROJECTS

In June 1999, the World Bank approved a loan of US$ 25 million for a project aimed at developing the banking sector of Uzbekistan. The objective of the project is to strengthen commercial banks’ corporate governance and improve banking legislation. In addition, it will strengthen the supervisory function of the Central Bank.

Material in this section is provided by lawyers of the EBRD’s Legal Transition Team:
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Joachim Menze – Latvia, Moldova, Romania, Slovak Republic, Ukraine, Secured Transactions Project.
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In the framework of its country programme for Russia, the OECD Centre for Cooperation with Non-Members (CCNM) organised a high-level experts meeting on “Corporate governance in Russia”, which took place in Moscow from 31 May to 2 June 1999.

The meeting received broad support from Russian institutions, and notably from the Supreme Arbitrazh Court, the Federal Securities Commission (FSC) and the National Association of Securities Market Participants (NAUFOR), a self-regulatory association. It was co-sponsored by the World Bank and the US Agency for International Development. Participants included policy makers and senior government officials, investors, representatives of business and social partners, governance experts and other international organisations. The discussion focused on a number of issues, including the ownership and control environment, the legal framework for corporate governance and its implementation, and the relationship between shareholders and enterprises in Russia.

The OECD has been involved in Russian legal and institutional enterprise reform since 1992. The programme originally focused on mass privatisation but has also emphasised such issues as disclosure, insolvency and corporate law reform. At an OECD meeting in 1998 on “The rule of law and the development of a market economy in the Russian Federation”, corporate governance was identified as a key area where structural reforms and the strengthening of institutions needs to be pursued.

This recommendation also coincided with growing interest in corporate governance from OECD countries, sparked in particular by the Asian financial crisis. As a result, OECD ministers asked the Organization last year to develop a set of corporate governance principles that could be useful to OECD members and non-member countries alike. The endorsement of the Corporate Governance Principles at the OECD annual meeting of Ministers a few days prior to the Moscow corporate governance meeting reinforced the value of using the principles to benchmark and gauge progress in this area. Conference participants agreed that there is great scope for using the principles as a template for reform.

The following is a summary of the main themes and recommendations which arose at the meeting in Moscow.

Main issues

The changing environment of ownership and control in Russia

It is clear that Russia’s corporate governance reform effort must inevitably take into account the specific characteristics of the country, the legal and cultural traditions, and the underdeveloped market environment in which its companies operate. However, as capital markets are becoming global, it is important that Russian corporations apply some minimum standards of good corporate governance in order to attract investment.

The ownership and control environment has been significantly altered since the 1998 financial crisis. As a result of the weakened financial sector, banks as owners cannot be expected to play an important role in leading the corporate restructuring effort, at least in the near future. Although the state remains a shareholder in a number of firms, its financial weakness and inability to exercise control has put their role both as a shareholder and as a credible source of financing in question. In contrast, foreign direct investors and portfolio investors who were largely absent as owners in the past could play an important role in promoting good corporate governance. In the short term, enterprise managers could also play a prominent role by taking responsibility for encouraging corporate restructuring. Their stance could be changing from general suspicion regarding outside investment to a more receptive attitude, recognising the importance of investment for the survival of enterprises.

Equitable treatment of shareholders and other stakeholders

Minority shareholders in Russia have often faced a range of improper practices, including asset stripping, improper transfer pricing, share dilution, restricted access to shareholder meetings and the barring of outside investors from taking seats on the board of directors. These practices are harmful to the development of enterprises and the attraction of outside investment.
Self-dealing transactions are common practice, in particular asset stripping. Transfer pricing is widely used by holding companies to transfer value from their subsidiaries and outside investors to a holding structure. Profits usually end up with the management-controlled company. Although the equity market is on a downturn, new share issuance is on the rise. This is often the result of efforts to dilute holdings of minority investors. Companies frequently fail to comply with the laws that regulate share issuance, such as adequate pre-notification for the exercise of pre-emptive rights. Obstruction of share registration is also prevalent. While independent certified registrars must maintain most share registers, some are still in the hands of the company's management. Therefore, minority shareholders seeking to assert their rights may be confronted with the company manipulating the register.

In Russia, managers often undertake major strategic moves without the consent of shareholders. In order for shareholders to influence the decision-making process in a company, it is important that they can exercise their voting rights at the Annual General Meeting (AGM). In order to do so, shareholders need to be furnished with sufficient and timely information regarding the date, location and agenda of the AGMs, at which there should be an effective means of shareholder participation and the possibility of having their views represented through the proxy mechanism. Enterprises should be encouraged to broaden participation by enlisting the use of modern technology, including telephone and electronic voting.

Another important instrument for ensuring equitable treatment of shareholders is the board of directors. This tool has not yet been adequately exploited in most Russian companies, where there is often blurred responsibility between management and the board. The board should be accountable to all of the company's shareholders, ensure the fair treatment of other stakeholders and corporate compliance with applicable laws and regulations. Companies should be encouraged to engage a sufficient number of independent non-executive board members where there is a potential for conflict of interest or where independent business judgement is advisable. Russian companies that have introduced this measure are seeing positive results in terms of access to outside investment.

Much remains to be done in order to improve the implementation of company law. Shareholders should be encouraged to use the legal remedies it offers to protect their rights and to take grievances to the proper regulatory authorities. The Arbitrazh Courts should be assisted in building the infrastructure and expertise necessary for interpreting the law in an objective and efficient way. Furthermore, the FSC should be given the means to enforce the recently adopted Law for the Protection of Investors.

Improving the integrity of markets

The Russian market suffers from a considerable lack of transparency regarding financial, ownership and corporate governance arrangements, especially in corporate groups. Experience in countries with large and active equity markets shows that disclosure has been a powerful tool both for influencing the behaviour of companies and for protecting investors. A strong disclosure regime is a key feature of market-based monitoring of companies and is central to shareholders’ ability to exercise their voting rights. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to make informed decisions about the acquisition, ownership and sale of shares. Disclosure has often proven to be more effective than detailed prescriptive rules. Through the specialist press and other reputable agents, it also helps improve public understanding of the structure, activities and policies of enterprises. Ultimately, enhanced transparency and disclosure can be expected to help the growth and deepening of financial markets, encourage the efficient use of capital and build confidence through predictability, from which the whole society can benefit.

In Russia, the inadequacy of accounting rules and standards has impeded the development of an effective disclosure regime. The necessary reforms of accounting legislation have not yet been completed and the accounting rules issued by the Ministry of Finance are driven by tax considerations. Companies with international investment have the option to use international accounting standards while at the same time preparing accounts according to Russian rules, but smaller companies cannot afford such a dual accounting option.

In addition to financial disclosure, transparency of ownership arrangements must be enhanced. Too often, shareholders disguise their ownership by buying shares through one or more offshore companies, which are not easily traceable to the owner. This undermines the effectiveness of rules on interested party transactions, insider dealing, conflicts of interest and anti-monopoly policies.

The FSC has a fundamental role in ensuring effective transparency and disclosure as the securities market regulator. In the past, its power was limited by the lack of legal and administrative enforcement tools. The recently enacted law on the protection of investors’ rights is expected to give the FSC more leverage in this regard, such as new fines and sanctions for violations. The law affects all market participants, including issuers, intermediaries, investors and regulators. This legislation is viewed as a welcome sign that the Russian authorities are taking steps to minimise foreign investor risk. Self-regulatory associations, such as NAUFOR and the Professional Association of Registrars, Transfer-Agencies and Depositories (PARTAD), are expected to play a prominent role in developing business ethics in their area, while efforts to set standards by accounting/auditing professional bodies will also be very important.
Corporate governance practices in Russian enterprises

The discussion on the legal instruments underpinning the corporate governance environment in Russia revealed that, on the whole, they are adequate. However, the adoption of corporate governance rules in itself is not enough to substantially improve the performance of Russian enterprises. There is a great need to enhance the infrastructure in order to encourage effective implementation and enforcement of these rules. In this regard, it is important to sustain the emergence of a set of intermediary market institutions to help keep shareholders informed and to assist them in exercising their control rights. A lot can also be done at the voluntary level, including the continuing education of corporate managers to bring about the behavioural change at the enterprise level, without which reforms may not become effective.

Most importantly, Russian enterprises should realise that better corporate governance serves their own self-interest. To attract financing, enterprises have to produce some value for outside investors, ensure transparency of their financial management and, most importantly, relinquish some of their control over corporate decision-making. In this regard, a strong partnership between shareholders and stakeholders (managers and employees) in companies could be an important way of achieving change.

Case studies on Norilsk Nickel and United Energy Systems demonstrated the impetus for corporate governance reform at the enterprise level. Corporate decisions are increasingly driven by the need to access financing in international markets. The treatment of shareholders and other stakeholders has a direct impact on the capacity of companies to survive and prosper in the global marketplace. In this regard, the financial crisis has been a catalyst. As liquidity started to dry up, enterprises became confronted with the realities of market forces and the importance of building a strong corporate governance framework. Managers are starting to appreciate the value of establishing closer dialogue with shareholders. Some large Russian companies have created investor relations departments and even introduced corporate governance charters. However, much remains to be done to improve the channels of communication with minority owners.

The discussion on foreign investors’ expectations highlighted some of the obstacles to foreign investment and generated some recommendations on how to meet these challenges. Weak corporate governance has emerged as the most serious impediment to foreign investment in Russia. Not only does it drive investors away from specific Russian corporations, it also creates a negative image for the whole Russian corporate sector and thus deprives even transparent and honest enterprises from attracting investment. Investors are particularly concerned with disclosure and transparency issues, such as the reluctance of some Russian firms to provide adequate financial, operating and strategic information. Foreign investors are also concerned about a lack of equal treatment of foreign and domestic shareholders by courts and local authorities. In this respect, corruption is a major impediment.

A collective effort to introduce a code of ethics, supported by professional associations, major companies and investor groups, would be important. This could complement efforts at the regulatory and enforcement level as well as help the emergence of a culture of compliance and disclosure. As participants pointed out, such an effort could be based on the OECD’s principles.

Role of the state as a shareholder

The Ministry of State Property remains a majority shareholder in over 12,000 state-owned enterprises and a minority shareholder in over 3,800 companies with no coherent set of goals to exercise its ownership rights. Assets are managed mostly via state boards composed of 2,000 members of ministries and agencies. Coordination between them is poor and their powers are ill-defined.

Using privatisation as a tool for improving corporate governance and creating better capital markets has met with success in many countries, including emerging and transition economies. In Russia, privatisation has not yielded entirely satisfactory results due to the lack of a transparent and competitive process. The success of future privatisation efforts will depend on their openness and competitiveness. Moreover, in the wake of the financial crisis, privatisation may be used as a tool to introduce foreign investment and broaden capital markets.

Another concern is the current trend to re-politicise property management by shifting responsibility over ownership rights from the Ministry of State Property to individual ministries. This is likely to further blur the lines of accountability. It is important to distinguish between the role of the state as a regulator and a shareholder. As a regulator, the state should address public interest concerns in natural monopolies and infrastructure sectors. Specific institutions should fulfil these functions. These should be different from state agencies holding and managing shares of state-owned enterprises.

Conclusion

While external developments have contributed to Russia’s economic hardship, it is now widely recognised that structural policy shortcomings in the investment process, including the lack of effective corporate governance mechanisms, have been an important factor. It is true that many foreign investors exhibited little prudence in providing financing regardless of the lack of transparency of corporate governance arrangements. However, there is a growing awareness that one of the vital conditions for investors to return to Russian companies is an improvement in corporate governance mechanisms. Enterprises that have introduced transparency, accountability and independence at the board level have seen their wealth preserved and investors still willing to support them despite the overall country market risk. Thorough restructuring of the financial sector in the wake of the crisis...
might also represent an opportunity for a more transparent corporate governance structure and the establishment of an arm’s-length relationship between banks and corporations.

A number of recent corporate governance abuses have generated intense discussion about the future of Russian enterprises in the coming years. Investors have often seen their shares diluted by insiders and major shareholders. Enterprises have been stripped of their assets by various means of transfer pricing and other related transactions. The interests of creditors have not been adequately protected. Poor corporate governance practices have hampered the mobilisation of outside capital and cultivated conflicts of interest. These weaknesses have been compounded by serious deficiencies in the tax and accounting systems as well as institutional structures.

Russia has achieved substantial progress in enacting essential economic legislation during a relatively short time-span. However, important work remains to be done to allow better corporate governance to emerge. This includes:
- strongly encouraging competitive processes in the market for corporate control, including reducing barriers to entry, promoting de-monopolisation and facilitating efficient market exit;
- implementing and enforcing existing laws and regulations by strengthening the institutional capacity of the judiciary and regulatory authorities (mainly the Supreme Arbitrazh Court and the FSC) and deepening the understanding of the issues involved; and
- improving the business culture by raising awareness of these issues in Russian enterprises and building private institutions that will foster the development of business rules and ethics.

Increasing the responsibility and role of enterprises could encourage the development of an accountable and transparent corporate sector, an important prerequisite for a more open economy and society, with integrity and accountability at all levels.

What’s next

The Moscow conference succeeded in identifying the future direction of the policy discussion on corporate governance in Russia, using the OECD’s principles as the main tool. One of the most important results of this meeting is the establishment of a permanent dialogue structure, “The Corporate Governance Round Table for Russia”. The Round Table will be co-sponsored by the OECD and the World Bank and will be set up in co-operation with the main Russian institutions, both public and private, that actively backed the June meeting. This would help raise and maintain momentum for corporate governance reforms and ensure high-quality advice for the public and private sector decision-makers involved in this effort.

The Round Table’s primary functions will be to:
- promote good corporate governance by using as a starting reference point the OECD’s principles and to further develop them to address Russian concerns;
- generate dialogue on these issues and disseminate international experience and best practice by bringing together on a regular basis public and private sector experts from OECD countries and, possibly, other transition economies with their Russian counterparts;
- identify areas for further work at policy level and to help identify technical assistance needs in the private and public sectors; and
- make recommendations for policy implementation and to regularly review progress and take stock of corporate governance developments.

The first meeting of the Round Table is planned for early 2000. In addition to its regular meetings, the Round Table may organise smaller meetings of experts on selected subjects. It will also encourage frequent dialogue on improving corporate governance in Russia by setting up an Internet website and an electronic discussion group.
Seminar on telecommunications regulation and privatisation in Kiev

In cooperation with the European Commission, on 19 May 1999, the EBRD organised a seminar in Ukraine on telecommunications regulation and privatisation. The main objective of the seminar was to provide members of the Ukrainian Parliament and senior civil servants with information on some of the recent privatisations in central and eastern Europe as well as the most recent trends in telecommunications regulation.

EBRD representatives, Lindsay Forbes, Marykay Fuller, Meni Styliadou, Mark Dutz, Ken Lomnen and Franck Noiret, described to the Ukrainian participants their experience regarding telecommunications privatisation in Romania and Moldova as well as the result of an analysis carried out by the EBRD’s Office of the Chief Economist on the performance of the company, the quality of service, etc. A presentation on the Hungarian privatisation was made by a director from the Hungarian Ministry for Telecommunications. Presentations were also made on the difficult issue of tariff rebalancing and on the recent trends in telecommunications regulation in the European Union.

Seminar on financial market law reform in Luxembourg

On 25 March 1999, under the sponsorship of the Government of Luxembourg, the EBRD participated in a seminar on the reform of banking and capital markets laws in transition countries. The seminar, held in Luxembourg, was organised by George Heinen, the Bank’s Alternate Director for Belgium, Luxembourg and Slovenia, in connection with the publication of the spring 1999 issue of Law in transition, which focused on financial markets law reform and was sponsored by the Luxembourg Government. Participants in the seminar included Minister of Justice, Minister of the Budget and other officials from the Government, lawyers, certified public accountants and other professionals.

Speakers at the seminar from the EBRD included George Heinen, Hsiannmin Chen and Jonathan Harfield. Gerard Sanders, Assistant General Counsel, gave a presentation on the legal transition programme of the EBRD. Hsiannmin Chen, Counsel, focused on a specific legal technical assistance project, i.e., close-out netting legislation, to indicate how the EBRD delivers legal technical assistance to its countries of operations under the Bank’s Legal Transition Programme. The presentation made by Jonathan Harfield, Senior Banker and Country Team Director for the Czech Republic and the Slovak Republic, concerned money laundering in central and eastern Europe.

Meeting of IOSCO’s Committee on the Implementation of “Objectives and Principles of Securities Regulations” in Lisbon

On 22 May 1999, the Committee on the Implementation of “Objectives and Principles of Securities Regulations” advocated by the International Organization of Securities Commissions (IOSCO) held a meeting in Lisbon. This meeting was organised to, among others, explore how IOSCO could co-operate with other international organisations in implementing IOSCO’s “Objectives and Principles of Securities Regulations”. Hsiannmin Chen, Counsel of the EBRD’s Legal Transition Team, made a presentation to report the results of an EBRD survey on capital markets laws in the countries of central of eastern Europe and the CIS. The occasion was a further opportunity to enhance coordination among providers of legal assistance for the development of securities markets.

International Bar Association conference on “The European Union Goes East – Impact of the Acquis on Investment in Central and Eastern Europe” in Prague

The conference took place in Prague on 17-19 May 1999 and was hosted by the IBA’s East European Forum and the Czech Bar Association. Attendees included representatives of the governments of east European states and international financial institutions as well as private lawyers. The conference agenda focused primarily on the Czech Republic, Hungary and Poland, with some discussion on developments in the Slovak Republic. Discussions centred on the latest developments in competition, procurement, company and capital markets law and regulation, with an emphasis on changes in law as a result of countries adopting the acquis communautaire. David Bernstein, EBRD Chief Counsel, presented the results of the EBRD’s legal surveys on financial market regulation and provided a description of the Bank’s efforts in assisting with the development of well-regulated capital markets. A consistent theme among the presentations at the conference was the need for these countries to continue to update their commercial legislation to bring it in line with the acquis while focusing on and financing the development of institutions that can effectively implement these new laws. Hungary and Poland were singled out as examples of how to achieve this.
Global Corporate Governance Forum planning session in Washington, DC

On 29 July 1999, the World Bank and the OECD hosted a planning session for the Global Corporate Governance Forum that will be initiated at the World Bank/IMF Annual Meetings in Washington in late September of 1999. The Global Corporate Governance Forum is a "joint-venture" between the World Bank and the OECD designed to help promote the development of sound corporate governance practices in developing and transition countries, using the OECD Principles of Corporate Governance as a starting point. The Forum secretariat is presently funded by the World Bank, where it will also be based.

The Forum is directly supported by a Private Sector Advisory Group (PSAG) chaired by Ira Millstein, Senior Partner, Weil, Gotschal & Manges LLP. Its membership includes Mark Moibus, President, Templeton Emerging Markets Fund, Inc., Michel Albert, former Chairman, Assurances General de France, Yoh Kurosawa, Chairman, The Industrial Bank of Japan, and other leading business representatives from around the world. The PSAG will support the Forum by attempting to convince their private sector colleagues in developing and transition countries of the need for corporate governance reform.

During the planning session representatives of international financial institutions, organisations and individuals active in promoting sound corporate governance and business representatives discussed ways in which the Forum could support existing corporate governance initiatives. There was a consensus that the Forum could serve as a clearing house and resource base for ongoing efforts. In particular, the role of the PSAG was seen as vital for identifying reform champions and building up momentum for reform in developing and transition countries. The OECD announced that it would initiate a series of corporate governance round tables in specific countries, along the lines of its Russian round table, in an effort to start a reform dialogue among government, the private sector and foreign investors.

World Bank insolvency symposium in Washington, DC

On 13-14 September 1999, the World Bank hosted a symposium of insolvency experts as a first step in its efforts to identify principles and guidelines for sound insolvency systems and for strengthening related debtor-creditor rights. This insolvency initiative is part of the wider G-7, G-22 and IFI effort to improve the future stability of the international financial system. The World Bank has formed an Advisory Panel comprising representatives of international organisations, including the EBRD, to guide the effort and to assist a Task Force comprising leading insolvency experts from around the world. The Task Force is charged with taking the results of the symposium, contained in ten working papers, and developing draft principles and guidelines. The working papers and the draft principles and guidelines will be available for review and comment on the World Bank’s legal insolvency database under the site heading for “Best Practices” later this year.
This two-volume glossary is designed to aid mutual understanding between the Russian-speaking and international business communities. Compiled by the European Bank for Reconstruction and Development, it covers the latest banking, economic and legal terminology. Available in both Russian-English and English-Russian at £50 each or £90 for the set.

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