

# The Legal Framework for Effective Corporate Governance: Comparative Analysis of Provisions in Selected Transition Economies<sup>1</sup>

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## 1. Introduction<sup>3</sup>

We define ‘corporate governance’ as the set of rules and mechanisms governing the behaviour of a firm which ensures that shareholders, investors and creditors are protected from abuse by managers and large stakeholders and have sufficient incentive to supply the firm with finance and credit. The development of market economies in Central and Eastern Europe, and the imminent accession of some of these countries to EU membership, has only strengthened the view that ‘corporate governance’ is of fundamental importance to the process of transition and to the economic regeneration and growth of former socialist countries. Indeed, fourteen years of ‘post-socialist’ development has shown that as the institutions of the new market system develop, more advanced, complex and intricate mechanisms of corporate governance are needed to ensure the protection of shareholders, investors and creditors who are the vital agents of a dynamic economy. The ‘needed mechanisms of corporate governance’, initially highlighted by Frydman, et al. (1993) are even more important now that these countries have established a market system and, at least some of them, are nearing the end of the transition phase.

Shleifer and Vishny (1997) argued that effective corporate governance is established either through a well developed legal framework and an active capital market, or through concentrated ownership. In an extension of this argument, La Porta, et al. (1997 and 1998) argued that in countries with better legal protection of shareholders, financial markets are more developed and firms have greater access to external finance and better opportunities for growth.<sup>4</sup> This analysis was extended to transition economies by Pistor, et al. (2000) by highlighting the effectiveness and impact of legal institutions on external finance. While La Porta et al.’s work was concerned with the analysis of ‘anti-director’ rights of shareholders, Pistor’s work focused on additional dimensions such as the legal provisions for voice and exit, and the ability of shareholders to resist block-holders.

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<sup>4</sup> Similarly, in a comparison of the regulations governing the Polish and Czech stock exchanges, Gleaser, et al. (2001) showed that because of the regulations protecting the interests of investors and minority shareholders, it was possible to raise over a billion dollars of finance for new and existing firms in Poland and launch 138 IPOs (until 1998) while none of this was possible on the Prague Stock Exchange.

Furthermore, the interpretation of the traditional agency problem (i.e., the conflict between owners and managers) was extended by the work of La Porta et al. (1999), Berglof and von Thadden (1999) and Pistor et al. (2000) to cover other conflicts of interest in firms (e.g., the conflicts between minority shareholders and controlling shareholders, between shareholders and workers, or between managers and creditors). La Porta, et al. (1999), e.g., showed that large companies around the world are generally dominated by concentrated ownership (families or governments) and that the protection of minority shareholders from (potentially) expropriating dominant shareholders lies at the heart of the corporate governance problem.

The ownership transformation process embarked on in many transition economies, especially those undergoing mass privatisation, gave rise to an initially dispersed ownership structure in mass privatised firms. However, since the mid-1990s, these firms have been undergoing a rapid increase in ownership concentration. The process of ownership concentration in mass privatised companies in Poland, Hungary and Slovenia has been demonstrated in detail by Blaszczyk, et al. (2003) - in the Czech Republic, e.g., nearly half of the Czech firms privatised in the mass privatisation scheme now have a dominant owner controlling over 50% of shares (Grosfeld and Hashi, 2003). A similar conclusion was arrived at by Berglof and Pajuste (2003) who focussed on the concentration of both ownership rights and control rights in large listed companies in twelve transition countries (including all accession countries). This increased concentration of ownership and control, and the emergence of dominant owners for firms in transition economies have highlighted the importance of corporate governance mechanisms, particularly those relating to the protection of minority shareholders and the disclosure and transparency requirements expected of the management – in short, the ‘voice’ and ‘exit’ mechanisms.<sup>5</sup>

In developed market economies the discussion of corporate governance and the need for improvements in the regulatory framework has continued. The OECD and EU member states, as well as multinational professional organisations, have all produced codes of obligatory and voluntary behaviour for improvements in the corporate governance system.<sup>6</sup> The legal framework and voluntary arrangements developed in these countries provide a benchmark from which transition economies can learn.

This paper aims at comparing the legal framework for corporate governance in selected transition economies in order to highlight the progress made so far as well as the shortcomings of the existing framework. The paper identifies the differences between the systems of corporate governance in various transition countries. The paper is divided into five sections. Each of the next three sections considers a particular aspect of the corporate governance framework as practiced in the selected countries. These are: shareholders’ rights; equitable treatment of all shareholders; and the responsibilities of company boards. These sections broadly correspond to the first three headings of the OECD Principles as well as other interested organisations (see footnote 3 for details). The paper ends with a conclusion.

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<sup>5</sup> For a discussion of voice and exit mechanisms, see Roe (1993) and Hashi (1998). The only exception to the generally accepted increased importance of corporate governance is Mihalyi (2002) who argued that with the growth of multinational companies activities in Central and Eastern Europe and the accession to EU membership, corporate governance becomes rather ‘irrelevant’. However, the limited influence of foreign firms in transition economies on the one hand and the continued interest in corporate governance codes and regulations in Western market economies on the other, particularly in the light of the Enron and Worldcom scandals, contradict Mihalyi’s view.

<sup>6</sup> For a detailed comparative study of the regulatory framework in EU countries, see OECD (2002). Of particular relevance to this discussion are: the OECD Principles of Corporate Governance (OECD, 1999); the International Corporate Governance Network’s statement on corporate governance principles (ICGN, 1999); the European Association of Securities Dealers’ corporate governance principles and recommendations (EASD, 2000); and the Euroshareholders Corporate Governance Guidelines 2000.

The data for the analysis of each section was collected through a questionnaire on various aspects of corporate governance completed separately for each country. The respondents were lawyers, economists, academics, researchers and stock market participants, i.e., professionals involved in the study and/or practice of corporate governance (see Appendix 1 for Questionnaire).

## 2. Shareholders' Rights

Shareholders' rights are the subject of Principle I of the OECD code of good practice and are fundamental to any corporate governance system. The separation of ownership and control and the potential principal-agent conflict in joint stock companies underline the importance of emphasising shareholders' rights, especially the right to participate in the company's important decisions made at general or extraordinary meetings of shareholders. In order for this right to be exercised, the legal framework must establish procedures by which shareholders are duly informed of such meetings, in good time, so they can take part in the decisions of the company without any inconvenience or cost.<sup>7</sup> Furthermore, it is crucial that their geographic proximity to the company does not affect their ability to participate in the decision-making process.

The implementation of these provisions require, firstly, a secure register of shareholders and, secondly, the availability of postal voting and proxy voting options. While most of these requirements are common practice in OECD countries, they are not legal requirements in transition economies and in practice many of them fall short of meeting these criteria. Table 1 summarises the legal position on some aspects of shareholders' rights in selected countries.<sup>8</sup>

**Table 1. Aspects of Shareholders' Rights to Participate in Decision Making**

Countries	Independent Share register	Postal voting	Proxy voting	Notice of meetings
Albania	Yes	No	Yes <sup>b</sup>	Media or letters to shareholders
Bulgaria	No	No	Yes	Notice in State Gazette
Czech Republic	Yes	No	Yes (power of attorney necessary)	One national paper or letters to shareholders
Lithuania		Yes <sup>a</sup>	Yes <sup>a</sup>	Media or letters to shareholders
Macedonia	No	Yes	Yes	Public announcement or invitation letters
Poland	Yes	No	Yes <sup>c</sup>	Announcement method not specified <sup>d</sup>
Romania	Yes	No	Yes (power of attorney necessary)	Notice in State Gazette and a newspaper or by letters to shareholders <sup>e</sup>
Russia	Yes	Yes	Yes	By registered letters to shareholders <sup>f</sup>
Slovenia	Yes	No	Yes	Notice in national papers or company website

Notes:

<sup>a</sup> Only if the provision is allowed in the company's articles of incorporation.

<sup>b</sup> Companies with more than 50 employees only.

<sup>c</sup> On the regulated segment of the market.

<sup>d</sup> Notice of meeting *may* however be by letters to shareholders if shares are named shares.

<sup>e</sup> If shares are named shares.

<sup>f</sup> Or as the company charter determines (e.g., by invitation in the newspapers or television).

<sup>7</sup> OECD Principle II.A.3 states that companies should not make it unduly difficult or expensive for shareholders to vote at the general meetings.

<sup>8</sup> Another aspect of shareholders' rights is the right to be properly informed of the financial position of the company and material factors which may influence this position. This will be discussed later, under the responsibilities of the boards.

Clearly there are diverse arrangements for owners' participation in decision making in different countries although, in most areas, there is a noticeable trend towards conformity with OECD principles. Independent share registers seem to exist in most countries, especially the accession countries. Information on meetings is often communicated via the media rather than by letters sent to individual shareholders. Given the wide use of 'bearer shares', this seems to be a reasonable deviation.<sup>9</sup> The opportunity for postal voting is generally still not available in most countries and proxy voting, though technically possible, in many countries is often subject to the additional condition that the proxy must have an official power of attorney. Furthermore in some countries shares have to be deposited with a third party for a minimum period before the shareholders' meetings. These restrictions clearly weaken the ability of shareholders to participate and influence the company's decisions. Moreover, they provide fertile ground for abuse by controlling shareholders.

### **3. Equitable Treatment of All Shareholders**

The OECD code recommends that all shareholders (minority or majority; foreign or domestic) of each type of share be treated equally. An important aspect of 'equal treatment' is the concept of 'one share-one vote' which is practiced in many, though not all, OECD countries. According to this Anglo-American practice, all shares should have equal voting rights in order to provide owners with proportionate power to influence the decisions of the company. In many countries (including OECD countries), other practices such as non-voting shares, shares with greater voting power, etc. are common. In some countries there is a cap on the voting rights of large shareholders, effectively giving their shares less voting rights than that of minority holders. In these circumstances, minority shareholders exercise undue influence over the decision-making process. The OECD Principles do not choose one practice in preference to another, though in some countries different types of voting shares are either discouraged or being abandoned altogether (e.g., Denmark and Greece). ICGN (1999), also regards any deviation from one share-one vote as undesirable.

Another aspect of equal treatment is the treatment of minority shareholders in particular, who may be the target of opportunistic and sometimes fraudulent behaviour by majority shareholders. Indeed, the question of equitable treatment becomes crucial when large shareholders can exercise greater control rights than warranted by their ownership rights (either because of the dispersion of the shareholding or through the multiple voting right of some shares).<sup>10</sup> For this reason, specific mechanisms are needed to ensure that all shareholders are treated the same. Minority shareholders can be protected in a number of ways: (i) the so-called 'super-majority' requirement for certain important proposals put to the assembly of shareholders which enables minorities to block certain decisions (such as capital increase, liquidation, mergers, etc.); (ii) the imposition of a quorum for shareholder meetings; (iii) the allocation of a seat on the board to the representative of minority shareholders (the cumulative voting procedure); (iv) the entitlement to buy shares in proportion to one's current shareholding when the company's capital is increased and new shares are issued (the so-called 'pre-emptive right'); (v) the right to embark on legal action against the management on the basis of

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<sup>9</sup> A related issue of some concern, especially in transition economies, is the existence of 'bearer shares' which are very common. Naturally, with these shares, the possibility of proxy voting or postal voting is significantly limited as the company has no access to the identity of owners.

<sup>10</sup> Interestingly in many EU countries (notably Austria, Belgium, Germany and Italy), a majority of listed companies have controlling shareholders with ownership stakes in excess of 50% of shares (Barca and Brecht, 2001)

‘duty of care’ (the so-called oppressed minority rule).<sup>11</sup> Table 2 summarises the legal framework for the equal treatment of all shareholders and the protection of the minority. Here, too, most transition economies fall short of OECD recommendations.

**Table 2. Equitable Treatment of Shareholders (Including Minority Shareholders)**

Countries	One share-One vote is the norm <sup>a</sup>	Quorum for AGM (% of voting rights to be present)	Supermajority for important decisions (% of shares present)	Automatic right to buy shares in new issues	Oppressed minority rule	Right of minority shareholders to elect a board member
Albania	Yes	51%	75%	No	No	No
Bulgaria	Yes	None	67%	Yes	No	No
Czech Rep	Yes <sup>b</sup>	30%	67% <sup>d</sup>	Yes	Yes	No
Lithuania	Yes	50%	66%	Yes <sup>f</sup>		
Macedonia	No	50% <sup>c</sup>	75%	Yes	No	No
Poland	No	None	67% <sup>e</sup>	No	Yes	Yes
Romania	Yes	50%	75%	Yes <sup>g</sup>	Yes	Yes <sup>h</sup>
Russia	Yes	50%	75%	Yes	Yes	No
Slovenia	Yes	None	75%	Yes	Yes	No

Notes:

<sup>a</sup> In the course of privatisation in some countries, the so-called ‘golden shares’ were created, giving the government (as the holder of the golden share) additional powers. These are excluded from the table.

<sup>b</sup> But it is possible to impose a cap on the voting rights of individual shareholders.

<sup>c</sup> 50% of shares with voting rights.

<sup>d</sup> For delisting, a supermajority of 75% is required.

<sup>e</sup> Other important decisions require 75%, 80% and 90% of votes.

<sup>f</sup> Unless the AGM decides otherwise (a super-majority of 75% is required)

<sup>g</sup> Not a legal requirement but may be included in the Company charter.

<sup>h</sup> This is possible in law but has not been practiced yet.

Clearly, all countries have made some attempt to devise and improve their legal framework to ensure the equal treatment of shareholders including minority shareholders. The ‘one share – one vote’ principle seems to be the norm in most countries. In terms of minority shareholders’ rights, most countries impose a quorum and a super-majority requirement on the meetings of shareholders – though the accession countries seem to have less strict rules than non-accession countries in some areas (lower quorum for assemblies, and lower percentage of votes for decisions requiring super-majority).<sup>12</sup> Pre-emptive rights are observed in almost all countries (with the notable exception of Poland<sup>13</sup>) and the oppressed minority rule is on the statute book in most countries too. Interestingly, only in Poland and Romania are minority shareholders entitled to one seat on company boards (though the provision is not commonly used in practice in Romania). The ability of minority shareholders to sue the management for violation of the ‘duty of care’ principle has occasionally led to the abuse of the litigation process by the minority. Although such abuse is rare (see Blaszczyk, Hoshi and Wood-

<sup>11</sup> This list is not exhaustive but contains some of the more common ways of protecting the minority against abuse by large stakeholders.

<sup>12</sup> In the light of the possibility of abuse by minority, and in the presence of better legal framework, these seemingly less restrictive measures may not be too significant (see next paragraph). It should be added that, in some countries, some decisions of the boards require higher super-majority levels than indicated in Table 2 (for example in Lithuania a resolution aiming to withdraw shareholders’ pre-emptive rights require a 75% majority).

<sup>13</sup> It should be noted that the Polish law allows for companies to introduce “pre-emptive” rights (if they so wish) but, unlike other countries, it does not impose this restriction on companies. The same thing applies to the quorum for the assembly of shareholders.

ward 2003 for examples), policy makers should be aware of its potential existence and formulate mechanisms to discourage it.<sup>14</sup>

#### **4. Disclosure, Transparency and Responsibilities of Company Boards**

Company boards are where the interests of shareholders, block-holders and managers are articulated. They are also the place where different types of conflict of interest manifest themselves. For this reason, and following a number of inquiries and reports on the subject, many OECD countries have opted for provisions requiring a certain proportion of companies' board members (either on boards of directors or supervisory boards) to be '*independent*' of the company and its shareholders. These board members can claim genuine independence from managers and large shareholders (who usually elect their own nominees to company boards) so that they can make impartial judgements when conflicts of interest arise. Various codes of good practice strongly advocate the presence of a reasonable number of '*independent*' or '*non-executive*' directors on boards, numerous enough to maintain the boards' independence on crucial issues and conflicts of interest. Almost all transition economies have employed the so-called German model of the two-tier board system (a supervisory board and a management board).<sup>15</sup> Although, technically, there is a separation of functions within the two boards so that members of the former are almost by definition not involved in the day to day management of the company (i.e., they are non-executive), nevertheless they remain the representative of the owners – actually, large block-holding owners rather than all owners. The concept of '*independent*' members is very new and has still not found its way into the normal practice of even large companies in most transition countries.

Investment decision making by prospective investors as well as the effective operation of the market for corporate control and managerial labour market require accurate and timely information on various aspects of performance and ownership of companies. The responsibility for providing such information lies ultimately with company boards. Precisely for this reason, companies are required to publish accounts certified by independent auditors on a regular basis, while companies listed on the stock exchange are required to publish more detailed accounts more frequently.

Additionally, members of the boards and management are bound by various '*insider dealing*' laws aimed at preventing those privy to confidential and price sensitive information from using such information for their own gains. Also in order to minimise the abuse of power by board members, audit committees, remuneration committees and nomination committees, largely or wholly made up of independent members of the boards, are given the responsibility for overseeing the preparation of financial statements of companies and preparing proposals on the remuneration of board members and managers and nominations to the boards.

Financial markets and prospective investors are also concerned by the provision of information on the ownership structure of the company and the ownership interests of board members. Therefore legal requirements exist not only to declare the ownership stakes of

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<sup>14</sup> In Bosnia-Herzegovina, the 75% super-majority requirement of the Enterprise Law of Republika Srpska, has resulted in the inability of majority shareholders to change the inefficient managers and board members. The same law also allows for minority stakeholders to have a seat on the supervisory board.

<sup>15</sup> Needless to say, the two boards may be called differently in different countries (e.g., Board of Administration in Romania and Board of Directors in Russia, instead of supervisory board) though their essential features remain the same. The only exception to the two-tier board system is in Kosovo where the Regulation on Business Organisations (UNMIK 2001) establishes an Anglo-American style unitary board of directors for joint stock companies, though allowing the shareholders' meeting to decide on other board models. In Bulgaria too, at the early stage of transition, companies could choose either type of board.

board members but also to identify the firm's large shareholders and any owner reaching a threshold ownership level (3% in the UK and 5% in most OECD countries).

Finally, OECD Principle III recognises the rights of other 'stakeholders' in a company and encourages cooperation between companies and their stakeholders. The main stakeholders of companies are identified as employees, customers, creditors, suppliers and governments. Of these groups, employees have been selected for special treatment and offered various rights such as consultation and representation at supervisory board level. In transition economies, the situation is rather mixed. Although in countries with a history of employee participation (such as former Yugoslavia and Poland), it was natural for employees to be represented at board level, some countries without that background have also adopted the practice (e.g. Czech Republic). Table 3 summarises some of the characteristics of company boards and their membership, transparency and disclosure requirements in selected transition economies.

**Table 3. Boards, Disclosure and Transparency**

Countries	Independent members on boards	Independent auditors	Financial reporting requirement for quoted companies	Threshold for disclosure of ownership stakes	Obligation to make a purchase offer to other shareholders (threshold) <sup>e</sup>	Disclosure of managerial ownership and Remuneration	Tenure of general director (years)
Albania	No	Yes	N/A	None	None	No	3
Bulgaria	No <sup>a</sup>	Yes	Quarterly	5%		No	3
Czech Republic	No	Yes	Half yearly	5% <sup>d</sup>	40 and 50%	Partial <sup>g</sup>	5
Lithuania		Yes					4
Macedonia	No	Yes	Quarterly	10%	45%		6
Poland	No <sup>b</sup>	Yes	Quarterly	5%	50%	Yes	5
Romania	No	Yes	Half yearly	5%	50.1 and 75%	No	4
Russia	No <sup>c</sup>	Yes	Quarterly	5%	30%+ <sup>f</sup>	Yes	5
Slovenia	No	Yes	Annually	5%		Partial <sup>g</sup>	8

Notes:

<sup>a</sup> Except for public companies where 1/3 of the supervisory board must be independent.

<sup>b</sup> The Code of Good Corporate Governance, however, *recommends* that 50% of board members should be independent (for Treasury owned companies, however, the law requires that 3/5 of the board members should be independent).

<sup>c</sup> Recommended by the Code of Corporate Conduct but the practice is limited to some of the biggest companies only.

<sup>d</sup> Any outsider can find out the identity of shareholders once they reach the 10% threshold.

<sup>e</sup> A shareholder reaching this threshold must make an offer to buy out other shareholders.

<sup>f</sup> This obligation may be withdrawn by Company charter or AGM.

<sup>g</sup> Only total salary bill is disclosed.

As mentioned earlier, the concept of independent board members is at its infancy in transition economies (even accession countries) with only Poland and Russia having a *recommendation* to engage independent members on boards on a voluntary basis. Similarly the representation of employees on the supervisory boards is also rare, with Slovenia and Czech Republic the only countries with statutory representation of employees at board level. On the other hand, the need for independent auditors and regular financial reporting is well established in all countries under consideration, with some countries even having obligatory quarterly reporting.

The disclosure of information about beneficial owners of a company is recognised in all countries, with most of them now having a threshold of 5% (and other higher levels). In a majority of cases, the mandatory bid rule (the obligation to make an offer to buy out other shareholders once an owner reaches a certain threshold, between 30 and 50%) is also place to ensure that minority shareholders can exit without financial penalties if a controlling shareholder enters the scene. However, in some countries such as Russia, the effectiveness of this provision is reduced by the fact that some beneficial owners are simply ‘off shore’ companies and the true identity of their owners remains unknown. Furthermore, there is anecdotal evidence about the existence of cross ownership and pyramid holdings which also hide the true identity of beneficial owners (see Berglof and Pajuste, 2003 for examples).

The chief executives of companies in transition economies still enjoy a great deal of power. Their term of office is usually very long, between 3 to 8 years (mostly 5). In comparison with EU countries, this is rather long – the Cadbury Committee recommended contracts of 1 to 2 years for chief executives in the U.K. (Cadbury, 2002). Similarly, as far as the ownership stake and remuneration of managers and boards are concerned, most countries still maintain a veil of secrecy and, at best, provide partial information (such as the aggregate value of managerial remuneration and shareholding) for shareholders investors and markets.

In all countries there are legal provisions against the abuse of power by managers. Almost everywhere they are forbidden by law to engage in actions, in collusion with others, to artificially manipulate share prices for personal gain. It is also explicitly against the law to engage in insider trading (the use of price sensitive information for personal gain). In both cases penalties ranging from fines, prison terms and the loss of the right to be a company director are available to courts. The implementation and enforcement of legal remedies is, of course, weak and successful prosecution of a significant number of company managers has not taken place in the transition countries investigated, despite the numerous financial scandals and cases of abuse of power –e.g., *tunnelling* which resulted in financial crisis in the Czech Republic or the pyramid schemes whose collapse led to civil unrest in Albania.

Finally, it is important to note that although the legal framework for corporate governance in the countries under consideration is fairly well developed and comprehensive, it does not mean that their implementation and enforcement are equally well developed. Indeed, as many observers have noted, law enforcement and implementation is a general problem in transition countries. Many authors and institutions have reported on the development of the legal framework and its enforcement in transition economies in the last few years (La Porta et al., 1997; Pistor et al., 2000; Kaufman et al., 2002; and the EBRD ‘s *Transition Reports*, among others). These studies provide a ranking of the legal framework especially the ‘rule of law’ and the effectiveness of legal provisions in the financial sector in these countries. Table 4 summarises two of the recent studies on law enforcement in the countries under consideration.

**Table 4. Rule of Law and the Effectiveness of Financial Regulations**

Countries	Rule of Law		Financial Regulations Effectiveness		
	1997/98	2000/01	1998	2001	2002
Albania	n.a.	n.a.	2-	2-	3
Bulgaria	-0.15	0.02	3	3	4
Czech Rep	0.54	0.64	3-	3	4-
Lithuania	0.18	0.29	2	4-	4-
Macedonia	n.a.	n.a.	2	2	4-
Poland	0.54	0.55	3	3	4-
Romania	-0.09	-0.02	3-	3	4
Russia	-0.72	-0.87	2	2+	4-
Slovenia	0.83	0.89	3-	4-	4-

Source: Kaufman et al. (2002); EBRD (1999 and 2002).



Clearly, despite much improvement in the legal framework, the general state of ‘rule of law’ is still far from satisfactory in most countries. Russia, in particular comes out quite poor (indeed with some deterioration of its score) in the Kaufman et al.’s study while Poland and Czech Republic seem to be in much better position. In terms of the effectiveness of financial regulations, most countries have improved and reached a satisfactory situation though, in the light of our investigations, the improvement in 2002 seems rather surprising. Even then, all countries have still some way to go to reach the position of developed market economies (which would attract a score of 4+).

## **5. Conclusions**

Effective corporate governance is fundamental to the process of economic regeneration in transition economies. It improves the performance of enterprises by aligning conflicts of interest, and by reducing fraudulent and opportunistic behaviour. It enhances the quality of information available to participants in the capital market and facilitates access to external finance. All transition economies have made significant progress in developing a corporate governance framework and are moving towards adopting the OECD Principles on voluntary or statutory basis. Poland and Russia are amongst the group of countries with more developed corporate governance practices.

The board system in almost all transition countries is similar to the German two-tier model with a supervisory board (responsible for the strategic direction of the company and the supervision and monitoring of the management) and a management board (dealing with the operational and day-to-day management of the company). The shareholders’ ability to influence the boards by exercising their voting rights and participating in the decision making process is, however, somewhat restricted in many countries. The opportunity for postal voting is generally non-existent and proxy voting is subject to additional time consuming requirements such as the power of attorney. Both Poland and Russia need to make improvements in these areas to encourage and facilitate a wider exercise of shareholder rights. Another important area of improvement is the appointment of independent members on supervisory boards, something which none of the countries under consideration have achieved so far. The codes of good corporate governance practice in both Russia and Poland, however, recommend that independent members should constitute one-third to one-half of board membership.

In terms of the protection of minority shareholders, most countries have adopted measures such as the quorum requirement for shareholder assemblies and the super-majority requirement for important decisions. Other measures such as pre-emptive rights, the mandatory bid rule and the oppressed minority rule are only available in some countries. Poland is the only country where the minority shareholders are able to pool their votes and elect a member to the supervisory board of companies, but at the same time, it is also the only accession country without the automatic pre-emptive right. This is an area of improvement which should be considered at the time of the review of the legal framework. The protection of minority, of course, has to be weighed against the ability of majority owners to engage in entrepreneurial activities. The abuse of minority rights is a potential problem that countries have to be aware of and make legal provisions to avoid without restricting the rights of minority owners.

As far as the rights of other stakeholders are concerned, there are no explicit references in the corporate governance framework of any of the countries studied – the only exception being the recognition of employees’ right of representation at supervisory board level in some countries (Czech Republic and Slovenia, e.g.). There are no provisions for consultation and the involvement of, or the supply of targeted information to, creditors, suppliers or governments. The participation of employee representatives on supervisory boards is of course rec-

commended by the OECD Principles and is practiced in a number of EU countries. Interestingly in Russia, the practice is common especially in larger companies though it is not legally required. This is another area of improvement that companies can make without any adverse effect on the work of their management bodies.

Finally, in all countries, there are legal remedies for breaches of rules, ranging from fines to imprisonment and restrictions on the future employment of the managerial personnel involved. This is very important and necessary, though not sufficient, for discouraging fraud and misuse of position of influence. However, while legal provisions are fairly good in most countries, the implementation of the legal framework or 'law in practice' is far from satisfactory. In many countries, basic rules such as the registration of shareholders, information for assemblies and various rules designed to protect minority owners are not observed fully or implemented in a lax manner. In Poland, where rules applying to companies on the Warsaw Stock Exchange are quite strict, the same is not true for other companies. In Russia too, the level of implementation, apart from larger companies with public presence is fairly low. The identity of the beneficiary owners of many companies are hidden behind the 'off shore' company formula which reduces the confidence of investors in the laws governing financial market. It is in this area that authorities need to make further visible progress to reassure investors and creditors. The EBRD index of legal effectiveness shows a surprising improvement in all countries in 2002 over previous years. This improvement does not match other researchers' and the Bank's earlier investigations and has to be treated cautiously.

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## **Appendix 1. Questionnaire**

### **Mechanisms of Corporate Governance**

#### ***Participation in Decision Making at the Annual General Meetings of the Company***

1. Is the voting right of all shares equal, i.e., one share one vote? Or, are there some categories of shares which have a higher voting right than other categories?
2. Is postal voting for the Annual General Meetings possible?
3. Is proxy voting for the Annual General Meeting possible?
4. What is the quorum required for AGM meetings?
5. What is the majority needed for AGM decisions? Is a ‘supermajority’ (e.g. 66% or 75%) needed for some important decisions? Examples?
6. How is the AGM announced to shareholders? In newspapers (what kind of papers – national, regional, etc?) or by sending letters to shareholders?

#### ***Supervisory Board (or Board of Directors in Russia) and Management Board (or Executive Board)***

1. Are there ‘independent’ directors on the Supervisory Board? Is the practice common?
2. Are employees represented on the Supervisory Board or the Management Board? What proportion of Board members are employees? Is this representation required by law?
3. What is the usual tenure (length of office) of the General Manager of the Co.?
4. Can the Supervisory Board, or the Management Board or employees stop a hostile takeover?

#### ***Minority shareholders’ rights***

1. Can owners of substantial minority stakes elect a board member? Or is 51% of votes sufficient to elect a Supervisory Board member?
2. Does the ownership of 33% of shares entitle the owner to any specific rights (e.g., vetoing certain decisions of the Board, or electing a member to the Board)?
3. Can minority owners take legal action against directors for some of their decisions (oppressed minority rule)?
4. In case of capital increase, do existing shareholders have automatic right to buy new shares – and only if they refuse to do so, these shares can be sold to others?

#### ***Transparency and Monitoring Issues***

1. What is the threshold for the legal requirement to disclose the identity of shareholders? (5%, 10%, 33%, 50%?)
2. Is it possible to have ‘nominee shareholders’ and is it required by law to disclose the identity of the real owner or the nominee?
3. Is there a requirement to make an offer to all shareholders once important ownership thresholds are passed (33% or 50%)?

4. How frequently is the reporting requirement (annual, quarterly, monthly?) for companies quoted on the stock market and those not quoted? Is the requirement of the Stock Exchange more stringent than that required by law for companies not quoted on the Exchange.
5. Are salaries, bonuses, and shareholding of top managers and Supervisory Board members reported in the annual accounts of the company – or elsewhere?
6. Is there a legal requirement for Joint Stock Companies to be audited by independent auditors?

### *Others*

1. Are share prices on the stock exchange different from trading off the exchange? Are a significant amount of shares traded off the exchange?
2. Is it explicitly against the law for the managers to engage in collusion with other parties to artificially change the share prices? If so, what is the penalty for infringement? Fines, suspension from managerial posts for a period of time, or jail?
3. Is it explicitly against the law for those involved in share trading to use confidential information (insider trading)? If so, what is the penalty for infringement?
4. Is there an independent share registry in operation? What is it called? Is it the responsibility of a joint stock company or its shareholders to keep the share registry informed of any changes in ownership (above a certain level)?
5. How seriously are the laws on above issues enforced?
6. Is there a law requiring companies to pay shareholders a % of their profits as dividends.