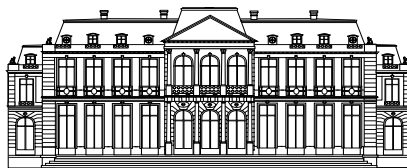


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CORPORATE GOVERNANCE IN ESTONIA

by

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PART I: INTRODUCTION AND SUMMARY*

1. The present report provides a review of the regulative basis of corporate governance in the Republic of Estonia, the existing situation, apparent tendencies and problems.
2. It is important to consider the following, in order to better understand the report:
 - All Estonian governments since the restoration of independence in 1991 have been leading the liberal economic policy. Estonia is open for foreign investments. There are no import duties. The state “does not rescue” enterprises facing bankruptcy.
 - The share and role of the state in economy have been steadily decreasing. Privatisation is reaching its final stage. Only some large (for Estonia’s scale) infrastructure enterprises (Estonian Energy Co., the Port of Tallinn, Estonian Railway Co., and Estonian Post) are still in state ownership.
 - The Commercial Code, which is based on the so-called German model, is in force since September 1, 1995. The Securities Market Act and Bankruptcy Act have been approved.
 - The Tallinn Stock Exchange began operating on June 3, 1996. The primary list of the exchange includes seven enterprises, the secondary list twenty. This also means that the stock market has not yet been established and the agents have little experience. The Stock Exchange is a private company, formed by the business enterprises trading at the exchange. The interior regulation of the stock exchange activities is provided by the Stock Exchange Rules and Regulations. The activities of the stock exchange are controlled by the Securities Inspectorate within the jurisdiction of the Ministry of Finance. The shares have been registered electronically; this is the sphere of the Estonian Central Depository for Securities.
 - The Estonian economic space and market are small. Medium and small enterprises are predominant. The investors, owners and top managers on the one hand and the politicians and government officials on the other are in most cases personally acquainted.
 - The stock market crisis hit Estonia in the end of 1997. Stock prices fell up to five times. The world economic crisis, which was triggered by the Asian crisis, and the Russian crisis, had a strong impact on the Estonian economy, but nevertheless did not change principally the structure of corporate governance (unless we consider the taking over of a number of Estonia’s leading firms by foreign capital).

* The views in this report are those of the authors and do not necessarily represent the opinions of the OECD or its Member countries.

This background paper was prepared within a set of guidelines provided by the OECD, in order to ensure homogeneity and render cross-country comparisons easier.

The data and discussion focus on large, mostly listed companies and corporate groups, although some observations on smaller companies are also made. No original research, such as new data gathering or corporate surveys was required. Authors were asked to survey existing data and published materials as well as examine legislation. However, sometimes unofficial data or anecdotal sources were used to respond to specific questions. In some cases, complete and well-supported answers to questions was not possible, due to a lack of data or due to irrelevance of specific questions in the context of individual country environments.

PART II: THE CORPORATE GOVERNANCE ENVIRONMENT IN ESTONIA

THE GENERAL ECONOMIC CONTEXT

3. The transition in Estonia from command to market economy began in 1990, at the time, when Estonia was factually still a part of the Soviet Union. The process accelerated after the restoration of actual independence in the autumn of 1991 and the monetary reform (the introduction of Estonia's own currency, the kroon*) in summer 1992. From that period on, Estonia's economic transition has been characterised by its very strong liberal features. For example, unlike other countries, Estonia has never used import tariffs (however, it is likely that they will be imposed on the import of agricultural products from those non-EU countries, with which Estonia has no free trade agreements covering agricultural products). No significant obstructions have been made to the free movement of goods, services or capital. Foreign investors are treated according to the same principles as the domestic ones (certain tax deductions were available for them in the earlier period). The role of the state interference in economy has been (as seen to the background of both the transition countries and market economic countries) extremely low. Certain state intervention has been considered necessary for regional policy considerations, but the limited measures used here have not permitted any significant regional political state activism. The principle of equal handling has also been used in regard of various types of businesses, the promotion of the SMEs has been considered important, but they have not been granted any significant concessions.

4. The state policy has been to keep the state debts low and the state has also been extremely stingy in extending its guarantees to investments. The principle of balanced national budget has been strictly observed. The tax level is moderate as compared to other countries. The privatisation of state-owned enterprises (with the exception of big monopolistic infrastructure enterprises) was successfully completed by year 1997.

5. The liberal and open policy as described above has contributed to the rather rapid restructuring of the economy. The services sector has rapidly expanded while the share of industry and agriculture of the GDP has decreased (see Table 1).

Table 1. GDP AS TO SPHERES OF ACTIVITY (CALCULATED IN CURRENT PRICES)

Sphere of activity	1991%	1996 %	1997 %	1998 %
Agriculture and hunting	15,0	5,2	4,3	3,8
Forestry		1,2	1,3	1,4
Fisheries	1,9	0,4	0,4	0,4
Mining	1,6	1,4	1,3	1,0
Manufacturing	32,7	14,8	14,6	13,7
Energy, gas- and water supply	1,7	3,6	3,1	3,4
Building	6,1	5,2	5,2	5,5
Wholesale and retail	7,2	15,3	15,1	16,2

* Exchange rate: 1 Estonian Kroon = US\$ 0.06856

sale				
Hotels and restaurants	0,8	1,1	1,1	1,3
Transport, storage and communications	6,2	9,7	10,8	12,2
Real estate, leasing and business services	1,6	8,6	8,6	9,6
Financial services	0,8	4,2	4,4	3,5
Administration	1,7	4,2	4,0	3,9
Education	2,4	5,0	4,8	4,9
Health care and social welfare	1,6	3,7	3,4	3,1
Other services	4,2	5,9	6,0	6,0

6. Foreign investments, predominantly from the West, have played a significant role in the development of the economy. As to the cumulative per capita FDIs, Estonia has held the second place in Central and Eastern Europe for a long time. In fact, Estonia seized the leading place in Central and Eastern Europe in 1998 as to the annual volume of per capita FDIs (\$407 per capita FDIs according to the World Investment Report). It is true that this is only one year's result, which primarily reflects the taking over of two leading Estonian banks by Swedish capital.

7. Estonian foreign trade made a sharp turn already in the beginning of the 1990s from the previous Eastern markets (the markets of the former Soviet republics) to the Western ones (predominantly the Nordic countries, especially the Finnish and Swedish markets). After Finland and Sweden joined the EU, the union became the dominating group of countries in the Estonian foreign trade. In 1998, 55% of Estonia's exports went to the EU and the Union provided 60% of Estonia's import. The role of the EU in Estonian foreign trade has increased after the Russian crisis. The most significant groups of goods in Estonia's export structure are machines and equipment (approximately 20% of export, although largely subcontract work rather than end products), timber and wooden products, textile and textile goods, food products. The share of the latter group has decreased after the Russian crisis.

8. The export of services is highly important for Estonia, due to the geographical location: the turnover of ports, ships, hotels etc. makes an important contribution to the balancing of Estonia's balance of payments.

9. Besides the positive results, Estonia's liberal economic policy has also had some negative consequences. These are the quite large current accounts deficit of the balance of payments (import has outpaced export during most of the transition period), the critical situation in agriculture, (which was partly caused by the export subsidies of the other countries) and problems with the increase of complexity of the production, especially the export production. (The share of low-value-added production and relatively low-paid labour-intensive production (including sub-contracts) is too large in Estonia's export).

10. There are also problems with the finding of finances for the development of the public sector, while the oncoming joining with the EU causes further pressure for the building up of a more expensive public sector.

11. The general deterioration of the global economic environment since the second half of 1997 resulted in the rise of interest rates, which in turn brought along problems with financial resources among the real economy enterprises and slowed down the economic growth. The rise of interest rates and the deteriorating state of the labour market slowed the growth of domestic demand. This in turn

was accompanied by a strong correction of the Tallinn Stock Exchange (in other words, crash). The latter event would have actually happened anyway and a number of analysts considered it an unavoidable punishment for the speculative pushing up of share prices, which allegedly was to a considerable degree an “achievement” of the Estonian commercial banks themselves. The stock market crash, however, had a weaker impact on the economy than had been expected, since its role in the financing of Estonian real economy had been too small to cause a greater setback.

12. The Russian crisis, which began at the same time, had a significantly greater impact. But the Russian crisis did not hit directly the Estonian banking as the Estonian commercial banks were not that closely linked to the Russian banks. On the other hand, the part of Estonian economy, which had been predominantly oriented at the Russian markets, suffered badly. This was primarily the Estonian food industry and especially the fishery and dairy industries. Since the food industry has also made considerable loans with the commercial banks in order to be able to operate in the Eastern market; the blow also indirectly struck the Estonian banks via the increasing share of bad loans.

13. But the worse outcome for the banks was the falling popularity of the emerging markets, which followed the Russian crisis and the escape of the short-term-oriented foreign capital. The banks faced considerable problems with the extension of credit lines.

14. Macro-economically speaking, Estonia could survive the financial crisis more or less satisfactorily (the fixed exchange rate held and the crisis even had a certain curative effect as the import slowed down faster than the export and the rate of inflation went down etc.), but the after-effect of the crisis was the take-over of a number of Estonia’s leading enterprises (both in banking and in industry) by foreign investors: Hansapank and Ühispank, the Rakvere meat-packing plant, the Marat textile firm, several media groups etc. The process is still going on and negotiations for the sale of one of the flagships of Estonia’s industry, the “Norma”, are in progress. It can actually be claimed that the financial crisis of the recent years with its after-effects handed over a greater part of the “cream” of Estonian industry to the foreign capital than the privatisation of industry, which had been conducted in the previous years and had been favouring foreign capital.

15. The general framework of Estonia’s economic and financial policy does not enable the government or the central bank to take strong active measures for the accelerating of the economy or bringing it out of a critical situation.

16. However, as the financial environment deteriorated, several restrictive measures were taken. Extra liquidity requirements were imposed on the commercial banks during the liquidity crisis of the end of 1997. The aim was to ensure that the banks would not expand their loans portfolios on account of the monetary system’s liquidity buffers in a deteriorating financing situation. In order to increase the banks’ liquidity buffers and to limit the increase of lending, the central bank (the Bank of Estonia) extended the calculating basis of the compulsory reserve in August-September 1998 by the sum of guarantees granted by the banks to financing institutions and non-resident credit institutions. The government’s conservative budgetary policy also supported the economy’s adjustment to a harsher environment in the first half of 1998, but it was relaxed in the second half of the year (in the period preceding the parliamentary elections).

17. The stability of the Estonian kroon was tested in autumn 1997 by speculative attacks against it, but it should be pointed out that the currency board system and the fixed exchange rate resisted the attacks well. According to the Bank of Estonia, the above measures served their purpose. A testimony to the improved monetary political situation and the end of the strongly restrictive policies

is also the fact that the Bank of Estonia began since summer 1999 to pay interest for the deposit of the compulsory reserves in the central bank.

CORPORATE GOVERNANCE CHARACTERISTICS IN ESTONIA

THE CORPORATE GOVERNANCE AGENTS

18. The following patterns of corporate ownership and finance have influenced the corporate governance environment. Estonia was the first region in the former Soviet Union, where already in 1986-89 co-operatives and some other forms of semi-private entrepreneurship started to boom. Part of these new enterprises really started as Greenfield ventures. Many co-operatives at the same time emerged as spin-off ventures on the basis of production or service units of large state-owned enterprises. At the first phase of price liberalisation these spin-off ventures had opportunity to make profit by using the resource base of their “umbrella-enterprise”. Often former managers of the sub-units of the state enterprise became leaders of new ventures remaining in the same time part of the “umbrella-organisation” business network. Top managers of umbrella-organisations, which still continued as state-owned enterprises, had vested rent-seeking interests in new ventures. This situation continued in some industries until 1992-1993 and has been changed by large-scale privatisation of state enterprises.

19. Relations between the top management of the state-owned enterprise and new enterprises renting its facilities and using its infrastructure could be sometimes compared to economic relations between landlords and landholders before agricultural reforms at the beginning of 20th century. A difference was that “socialist landlords” were often eager to share resources of enterprises between themselves and managers of spin-off ventures (“landholders”) without full payment to the “umbrella enterprise”. They sometimes even preferred to become spin-off “landholders” themselves. Although the legal and institutional framework of business has in recent years radically changed in Estonia such a mentality from early years of reform still has some impact on the real life corporate governance practices.

20. At the end of 1989 the Decree of the Estonian government settled the first legal basis for creating joint stock companies. Many co-operatives were transformed to joint stock companies and large number of completely new ventures was created as joint stock companies. At the beginning of 1995 the number of joint stock companies that were registered in Estonia was about 48,000. The total number of all enterprises was ~57 000 at this time. It was quite simple to create a joint stock company under the 1989 Decree. The minimum stock capital was only 300 Estonian kroons (less than 25 USD). Rules that had to be followed by the Board, reporting responsibilities of the CEO to the Board and the reporting by the Board to the General Meeting of Shareholders were not specified in detail by the 1989 Decree. Managing directors in many new joint stock companies were among larger shareholders and simultaneously in the role of the Chairman of the Board. This situation has been changing from September 1, 1995, when the implementation of the new Commercial Code started. This law sees joint stock companies (“Aktsiaselts” in Estonian) as public limited companies, which should have two-tier corporate governance system.

21. The minimum founding share capital of the public limited company (*Aktsiaselts*) was until recently 100 000 Estonian kroons, but it had to be increased to 400 000 kroons before September 1, 1999. This has been one reason why under the new Commercial Code other legal forms of entrepreneurship have gained more popularity.

22. On July 4, 1999 in the Central Commercial Register there were 8196 public limited (*Aktsiaselts*), 34 565 private limited companies (*Osühing*), 859 commercial co-operatives (they have different

legal status than co-operatives under the 1987 legislation) and 11 249 sole proprietorships. The number of companies in generals and specially the number of joint stock companies have however dropped in the process of increasing the statutory capital of existing companies as settled in the Commercial Code implementation articles. Both "Aktsiaselts" and "Osühing" indeed have the general meeting of shareholders as the highest governing body.

23. During the Russian financial crisis in 1998/99 several groups have been forced to sell out their acquisitions to foreign investors. There has been no special governmental policy for guiding the restructuring policy and/or to address the interface between the corporate and financial sector in the area of non-performing loans. In practice commercial banks have taken over bad debt companies and sold them mainly to foreign investors. Downsizing of operations has been often a feature of this process. Other large enterprises have gone through the bankruptcy process. There have been cases where large shareholders have succeeded to transfer before bankruptcy procedure essential assets of bad debt companies to new companies that are controlled by the same shareholders. Sometimes they have been assisted by creditor banks.

24. The direct intervention of banking with industry (with the exception of the activity of the investment funds formed by the Ühispank and the former Bank of Tallinn), has been relatively weak. The banks have interfered with the management of enterprises in only very rare cases (the cases of the TV1 television station and the troubled ITT company Pennu). Some analysts predicted in the summer of 1999 that since a large share of Estonian industry has run into trouble, a "major take-over of industry by the banks" would follow. However, this has not taken place so far. It is true that information leaked out in the end of September about Hansapank planning a serious intervention in the activities of the fishery sector, so as to recover the loans from the fishery enterprises. The alleged idea involves the merger of several fishery firms as the specialisation of enterprises to provide different (i.e. non-competing) products. It is not yet clear, how serious the "take-over of the fishery industry management" will be or what shape it will take.

25. The stock market and the stock exchange do not play a significant role in the financing of the corporations. The reasons are the current low at the stock exchange and the absence of free funds. Take-overs have become more frequent, especially by foreign firms. The take-over of the Hansapank and Ühispank by Swedish banks should be especially noted. No special anti-take-over devices are employed. Legal regulation is also absent in that respect with the exception of the Competition Act (in case of controlling 40 percent of the market, a special anti-price-rise control will be imposed). The implementation of this requirement is quite problematic due to the small volume of the Estonian market.

26. The activity of institutional investors is in the initial stage. The importance of pension, life insurance and mutual funds is not significant in this context. A peculiarity of Estonia is the existence and operation of the State Compensation Fund. This fund is quite active in the stock market by issuing bonds and participating in a number of companies. Estonia has no legal limits on equity investment.

27. Only the infrastructure enterprises out of the significant companies are in state ownership. The local governments are also considering the privatisation of the enterprises so far in their ownership. In accordance with the Commercial Code, the state as a shareholder is equal to all other shareholders, i.e. the state has no prerogative to other shareholders. The activities of the state, as, for example, the owner of 100 percent of shares, are unequivocally determined by the competence of the general meeting. The state is represented at the general meeting by the minister governing the given state property. The minister can exercise his will only via the Supervisory Board. The state can in no way

interfere with the activities of other privately owned companies and has practically no control over their activities.

28. The media have time and again pointed out possible corruptive relationship between the state and the companies, especially in the field of state procurements.

CORPORATE BEHAVIOUR, FINANCE AND RESTRUCTURING

29. Development of corporate groups in the Estonian economy could be described as several sub-processes. First, in some of large state-owned industrial and trade enterprises already at the end of 80-ies started the spin-off process, where small state enterprises, leased enterprises and later semi-independent subsidiaries were created. This process was not a manifestation of systematic restructuring effort but rather a way to use emerging entrepreneurship opportunities in more profitable business niches.

30. The rapid development of the Estonian financial sector in combination with the large-scale privatisation in the middle of 90-ies has lead to growth of some diversified corporate groups, which are partly controlled by banks and investment funds owned by these banks and partly by industrial enterprise owners. There are also managers of former state-owned enterprises among the latter, but as a whole, the role of the industrialists with former socialist economy background in Estonia is significantly lower than in many other post-socialist countries.

31. The leading figures of the banking sectors are predominantly businessmen of the new wave. The degree of diversification inside these groups is different. One could mention Hansa Group, where the core companies are Hansapank, investment, insurance and leasing subsidiaries. This group owns however shares in various industrial companies which has been partly the result of converting bad debt into stock. Similar pattern has the Ühispank Group, which covers besides the financial sector subsidiaries also food industry and real estate business.

32. There are groups that have emerged as the result of combining financial and real estate operations (Pindi Group). Diversification mainly inside the food processing industry has been the development path of the ETFC Group. Estiko Group, for example, has been diversifying from the plastic industry to the retail business and several other areas. Processing industry companies have tried to use their good-located production facilities for starting new department stores and other retail units. Norma Group has entered from mechanical engineering into food processing. Leading construction companies (Merko Group) have acquired sub-contractors and transportation companies. There are also opposite examples, i.e. movement towards specialisation. Historically the Estonian Central Association of Consumer Co-operatives has had quite diversified structure. This group is now in the process of selling of its industrial companies in order to concentrate to the retail and wholesale business.

33. Diversification of industrial companies has been in general to large extent an opportunistic attempt to make rapid use of existing facilities and other resources in the field where capital turnover is more rapid than in the manufacturing.

34. Internal governance structures of groups are yet in the unstable mode. Large shareholders of the total group may have the position of dominant shareholders in different subsidiaries of the same group. This situation is a source of conflicts in the group level decision making. Leading banks are quoted at the stock exchange as groups. It seems that industrial groups tend to be represented on the stock exchange by separate subsidiaries, not as an integrated group.

35. It is important to point out that while only 2-3 years ago at least ten major corporate groups could be considered in the Estonian economy, now after the financial crisis two clearly banking-centred groups dominate – the Hansapank and the Ühispank groups – while the total number of significant groups has greatly decreased. Several industrial enterprises or their groups belong indirectly to the area of co-operation of these two banks, although they are cannot be formally considered members of these groups (for example the Norma Group and the well-known sewing firm Baltika are known to be connected with Hansapank, Ühispank is has strong connections with the currently troubled ETFC group from the food processing industry, etc). It should not be forgotten that both above banks have been recently taken over by Swedish capital. It is not yet quite clear how the change of the bank's core owner will influence the expansion attempts of financial-industrial groups. It can be presumed that the Swedish owners' policy will have a restrictive rather than supportive position regarding diversification and expansion.

36. A tendency has become typical of Estonia in the recent years of private traders having very significant influence on state institutions. The traders' professional organisations – especially the Chamber of Commerce and Industry, the Association of Large Enterprises and the Confederation of Employers and Industry) - are very influential. The Supervisory Boards of main state-owned companies include representatives of the above-named organisations, who at the same time are personally active in business. The business leaders also demand that their interests be considered in the privatisation of infrastructure enterprises. At the same time, the Supervisory Boards of the state-owned companies are often politicised; i.e. they include politicians from the government and the ruling coalition parties. However, parliament members may not belong to Supervisory Boards of commercial enterprises. The Supervisory Boards' makeup changes together with the change of the government. The above situation can in no way be considered correct or practical. We are of the opinion that the Supervisory Boards of state-owned companies should be formed only of competent government officials. There is also the problem of whom does the Supervisory Board actually represent in case of a state-owned company. Instead of representing the state as an owner in the company, the Supervisory Board often represents the company at the owner. The Supervisory Board and the management co-operate against the state. The same can also happen in case of the private enterprises.

PART III: THE REGULATORY FRAMEWORK AND THE ROLE OF POLICY

EQUITABLE TREATMENT OF SHAREHOLDERS AND OTHER STAKEHOLDERS

SHAREHOLDER PROTECTION

37. In accordance to the Commercial Code, the equality and equal treatment of the shareholders are legally guaranteed. According to the general rule, one share equals one vote.

38. The shares of the listed companies have been registered electronically at the Central Stock Depository. The registers of shareholders and the number of shares they own are available to all interested parties for a modest fee. Unfortunately, in Estonia the shareholders of many companies are not known. Offshore companies and Estonian-registered shadow firms are used for this purpose. It is not compulsory that the owners of Estonian-registered companies be disclosed. This poses a problem in the society. Voting by proxy is legally and also practically possible and a widely used option.

Voting electronically is not possible. The shareholders' general meetings are mandatory. The Management Board, the Supervisory Board and the majority shareholders are frequently interested in holding formal meetings. The small shareholders are able to express their opinion, but their proposals are not passed at the voting. The generally spread opinion is that the small shareholder will always lose and if one wants to be an owner of a company, the ownership of more than 50% of shares is necessary.

39. The shareholders can make decisions only at the general meetings, whose competence has been determined in the Commercial Code as a definite list. The general meeting can discuss other issues only at the proposal of the Supervisory or Management Boards. Consequently, the shareholders need not approve the scheduled transactions. But the Supervisory Board of the company has to approve the major transactions.

40. All shareholders have proportional pre-emptive right at the issue of shares. This applies to the cases other than target issue. The shareholders are not entitled to information about the state of the company if the Management Board considers this information confidential.

41. Domestic and foreign investors have equal rights. As a result, a large number of enterprises have been privatised to foreign investors. One of the tendencies of the last years is the take-over of many significant enterprises by foreign companies or their merger with foreign firms. The main reason of this is the lack of free domestic capital and the owners' problems with the making of loans with banks.

42. The daily practice of corporate governance is increasingly characterised by various conflicts between the owners, the owners' representation (the Supervisory Board) and the executive management (the Management Board). In a number of cases the Management Board has concluded illegal or semi-legal transactions and driven the enterprise to bankruptcy. Conflicts between owners have also become more frequent, including conflicts between the small and majority shareholders.

43. Legal enforcement of the responsibility for the protection of interests of shareholders, including the small shareholders, by courts has still only few precedents (unfortunately, no statistics of court cases of this subject is available in Estonia). There were several cases of small shareholders learning about the transfer of controlling interest of the company to new owners only in the newspapers. In some cases of sale of controlling interest the small shareholders have been offered the option of selling their shares, but at significantly lower price than the shares of the controlling interest. Both types of cases have also occurred when Western firms have been the buyers.

44. Protection of minority shareholders is in practice weak, although some guarantees (right to call emergency general meeting of shareholders, right to demand special control of the Board etc.) are fixed in the Commercial Code. There are no special protection mechanisms of minority shareholders in the procedure of electing Supervisory Board and Management Board members.

45. A company is not allowed to guarantee the loan of a shareholder. The transparency of various transactions depends on the enterprise. The listed companies have developed special procedures based on the Commercial Code and the Securities Market Act. The Supervisory Board is to approve transactions different from the regular business activities. The Securities Inspectorate has established certain regulations to protect the shareholders against take-overs. But these measures can be taken only against investors operating in the stock exchange.

46. There is no legal obligation to extend the tender offer to all shareholders. Some enterprises have done this voluntarily. We believe that hostile take-overs are relatively usual in the present economic situation. Most of the details are known only by the parties involved in case of enterprises not listed on the Stock Exchange. There are cases, when even the board has no clear knowledge of the structure of ownership (offshore and shadow firms).

47. The legal regulation and tax laws do not regulate take-overs.

48. Insider trading is addressed in the Securities Market Act and the Stock Exchange rules and regulations. The Tallinn Stock Exchange has adopted rules of informing the public about reports and decisions of listed companies and principles for avoiding inside trading. Enforcement of quarter-based reporting requirements and other obligations have even lead to statements by some companies to leave the stock exchange.

49. A number of cases of suspected insider trading in the stock market have been revealed to the public. Insider trading is a problem. It is generally thought that the use of inside information in the stock exchange is general practice. There are certainly problems with the improvement of the Securities Inspectorate's efficiency. There are no court precedents. The court system as a whole is expensive and not always reliable.

50. The rights of the shareholders derive from the distribution of the stock and are as follows according to the Commercial Code:

- 50 percent of votes or more – to form the Supervisory Board and via this the Management Board;
- at least 2/3 of votes – the right to amend the articles of association;
- at least 10 percent of votes – the right to demand:
 - The convening of the general meeting
 - The inclusion of certain issues on the general meeting agenda
 - The notarised minutes of the general meeting
 - The resignation of a Supervisory Board member
 - The convening of the Supervisory Board meeting.

51. The above shows that 90 percent of the votes guarantees absolute power. As has been noted before, the Management Board may refuse to disclose information to a shareholder, regardless the percentage of stock. In principle, every shareholder is entitled to the bringing of a lawsuit against the management if he feels that his legal rights have been abused.

52. The Management Board member shall be liable only in case their illegal actions have been proven. The Supervisory Board can dismiss the Management Board at any moment without explanation.

THE ROLE OF THE BOARD OF DIRECTORS

53. Estonia has a two-tier board structure, according to the 1995 Commercial code.

54. The Board (in Estonian "Juhatus") or the Management Board is an executive body, which represents the enterprise and realises the decisions of the Supervisory Board. A Management Board member may not also be a member of the Supervisory Board and vice versa. The Management Board is elected by the Supervisory Board. The size of the Management Board has not been determined; it may consist of a single individual – the Director. The remuneration of the Management Board

members depends on their employment contracts. The contracts and salaries of the top management are confidential. Even the salaries of major state-owned enterprises have not been officially disclosed. This causes a problem in the society. Members of the Management Board do not have the right to be simultaneously members of the Supervisory Board.

55. The Management Board in an Estonian "Aktiaselts" is in majority cases the top management team and the Managing Director is the Chairman of the Board. The intention of the legislator has been to separate clearly the role of the top management representing the company in business with other legal entities on the Board level and the representation of owners through corporate governance as the main function of the Supervisory Board. Estonian business law experts participating in preparing the Commercial Code argued that their solution represents modern European trends in the corporate governance of public companies. The principle that the Managing Director should not be member of the representative body of shareholders has been also stressed in discussions concerning influence of boards in public companies of the United Kingdom and other West-European countries.

56. The Supervisory Board is the representative body of the shareholders. As the higher corporate governance body, it defines strategic priorities, approves the budget and major investment decisions and controls activities of the Management Board. The Supervisory Board shall consist of no less than three competent members, who need not be shareholders. The Commercial Code has no further requirements. The presence of the workers' and interest groups' representatives on the Supervisory Board is not required and does not happen in practice. The banks frequently demand that their representatives be included in the Supervisory Board as a condition of granting loans. The so-called mandatory voting is not used in the election of the Supervisory Board. Stock ownership above 50 percent grants the right to appoint the full Supervisory Board. However, this generally depends on the relations between the shareholders. The Supervisory Board of a listed enterprise usually consists of 5-7 members and may include representatives of various interest groups besides the banks. The Supervisory Board cannot conclude transactions in the name of the enterprise. A Supervisory Board member may not abstain from voting. The Commercial Code does not foresee the forming of committees on the Supervisory Board and this is not the practice. Most of the listed enterprises have an internal audit section. The Supervisory Board may receive remuneration for their work, but this is not required.

57. The work practice of Supervisory Boards in some large Estonian companies has demonstrated that members of these representative bodies might have vested interests and/or limited time resource for fulfilling active controlling functions. Supervisory Boards have made too generous "golden parachute" contracts with managing directors, especially in companies still owned by the state or municipalities.

58. Large shareholders of smaller "Aktiaselts" which are not public in the sense of being listed at the stock exchange or do not have dispersed share ownership tend to see two-level corporate governance system as bureaucratic burden. They face difficult choice: either to be Chairman of the Supervisory Board and to leave the role of Chairman of the Management Board and daily management rights to some other person or to act as the Chairman of the Management Board and to be formally controlled by other persons. The idea of the Supervisory Board as the brain trust for companies dominated by a few shareholders has not been widely accepted yet. An important challenge for many companies is to develop practices of efficient board work and to introduce internal rules of efficient decision making and interaction between the top management (the Management Board) and the Supervisory Board.

59. No significant initiative has been shown in Estonia for the amendment of the Commercial Code or the introduction of supplementary voluntary rules. It seems that the enterprises have adjusted to the regulation of the Commercial Code, in a number of cases, in-house procedure has been developed in order to determine the relations between the Supervisory and Management boards.

THE IMPORTANCE OF TRANSPARENCY AND DISCLOSURE

60. The Accounting Act of Estonia has been drafted in accordance with the internationally accepted standards. The Accounting task force is operating at the government, whose task is to determine and interpret possible problems and to ensure development.

61. Special rules of disclosure of information have been established for the enterprises listed at the Stock Exchange by the Securities Market Act and the Stock Exchange Rules and Regulations.

62. The information, which is not directly required to be disclosed, is disclosed if the company considers this necessary. Nevertheless, there is a general tendency of not disclosing information. No serious political debates are held concerning the disclosure of information. The companies are naturally attempting to cover up information unfavourable to them and to advertise favourable information. Numerical indicators concerning the companies listed at the Stock Exchange are generally reliable and available to all. Their interpretation is everyone's personal problem. There are problems with the disclosure of information concerning significant changes in trends influencing the enterprise's situation, for example, the change of markets, the process of negotiations with potential partners, etc.

63. The procedures of activities of the supervisory and management boards and their remuneration are not required to be disclosed and this is generally not done. Auditing is based in internationally accepted rules. The auditing of public limited companies is compulsory. The auditor is appointed by the owners.

64. The companies listed on the Stock Exchange are usually audited by well-known auditing firms (KPMG, Arthur Andersen, Price Waterhouse Coopers). The activities of the auditors are regulated by the Act of Auditing. There are approximately 420 active auditors in Estonia.

65. There have been no practical examples of court cases taken against auditors. However, complaints have been voiced via the professional organisation of the auditors and certain sanctions have been taken by it.

66. The financial accounting of the corporate group has been determined by the regulations of consolidation. The parent enterprise is treated in the Commercial Code as an ordinary shareholder. A public limited company shall not grant a loan of a shareholder, a member of the Management Board or Supervisory Board, a procurator of the public limited company or of its parent company, or persons with equivalent economic interest. No other regulations concerning the relations between the parent firms and subsidiaries have been established. The parent company is not liable for the activities of the subsidiary. There are numerous problems evident here, whose solution would require an improvement of the legislation.

PART IV: POLICY CONCLUSIONS

67. A legal framework of corporate governance, allegedly meeting the international requirements, has been developed in Estonia during the years since the restoration of independence. Due to the liberal economic policy and openness, the current legislation with its low level of regulation frequently provides advantages to majority shareholders. In order to avoid machinations and manipulations, the legislation needs to be improved, especially concerning the protection of small shareholders and the governance of groups.

68. There are a number of problems with ethics and business culture in the area of the implementation of the laws. This does not concern only the Estonian owners and managers, but also a significant share of the foreign investors. Certain problems are also connected to the training of the owners and managers. The importance of corporate governance as a specific sphere of activity is actually not recognised in the society. There are also practically no significant debates over these problems.

69. The improvement of the legislation is actually going on all the time. A new and improved Securities Market Act is being drafted. This is made necessary by Estonia's goal of joining the European Union. Within the nearest two years the entire legislation, including concerning corporate governance, will have to be harmonised with the requirements of the EU. It is true that the Ministry of Justice claims the Estonian Commercial Code to be already corresponding to the EU requirements.

70. Estonia's problem is, and, obviously will be for a number of years the implementation of the legislation, especially the taking of measures in case of violations. The backlog at courts also poses a problem.

APPENDIX 1

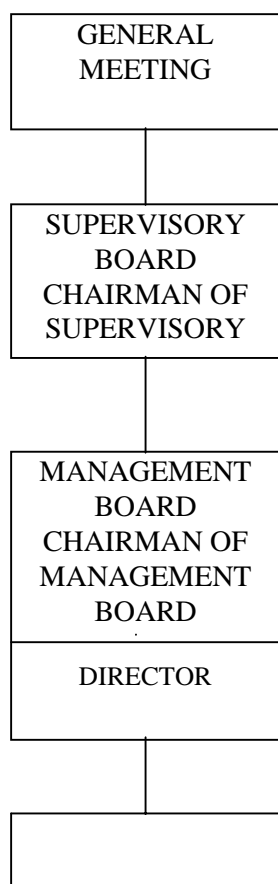
THE COMMERCIAL CODE – A BRIEF SURVEY OF TRADERS

	Founders	Basis of operations	Capital	Stock	Liability	Management
Sole Proprietorship	Any person	Registration at Tax Board	Not regulated	No	All assets	Trader
Partnerships General Partnership Limited Partnership	2 or more partners	Notarised partnership agreement. Tax Board	Contributions by partners, incl. non-monetary	No	Common and partner's assets	All partners
Capital companies 1. Private Limited Company 2. Public Limited Company	1 or more natural or legal persons	Notarised foundation agreement. Articles of association. Commercial register	1) share – shareowner no less than 100 kroons. Σ40,000 kroons 2) stock – shareholder, at least 10 kroons Σ400,000	1) no 2) May be: registered and bearer stocks	To the extent of payment	1) shareowners' meeting (Supervisory Board) Management Board 2) General Meeting (Supervisory Board) Management Board
Branch	Foreign firm	Commercial register	No	No	Foreign firm	Appointed director

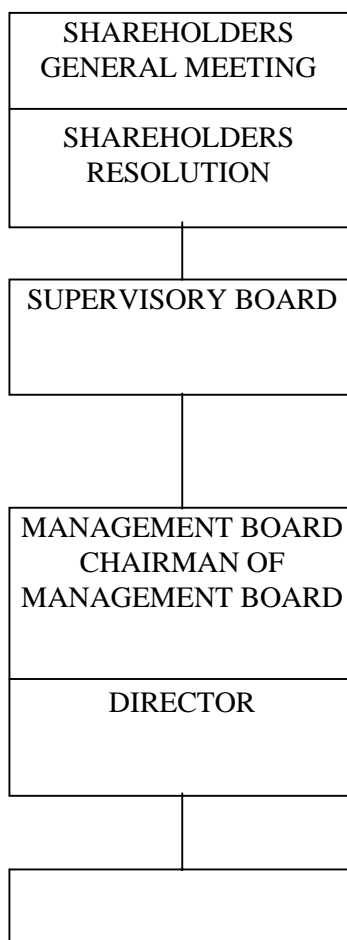
APPENDIX 2

CORPORATE GOVERNANCE BODIES

PUBLIC LIMITED COMPANY



PRIVATE LIMITED COMPANY



OWNERS: once per year
50 percent of votes
required

OWNERS REPRESENTATIVE BODY: no longer than 5 years, meeting once Three months

EXECUTIVE MANAGEMENT: no longer than 3 years, report to the Supervisory Board every 4 months

PUBLIC LIMITED COMPANY:

Competence of general meeting and Supervisory Board has been clearly defined. General meeting can discuss other issues only at the recommendation of the supervisory or management board. The competence of the management board is determined by the Supervisory Board, which can delegate its power to the management board.

PRIVATE LIMITED COMPANY:

Shareholders are entitled to make all decisions concerning the company. The Supervisory Board is to be formed in case of:

- Share capital exceeding 400,000 kroons and the company management board having less than 3 members

- The articles of association of the private limited company call for the Supervisory Board.